Review of the Taxation of Capital Gains in Canada

An examination of the Canadian experience
and of issues involved in proposals for change

November 1980

Department of Finance
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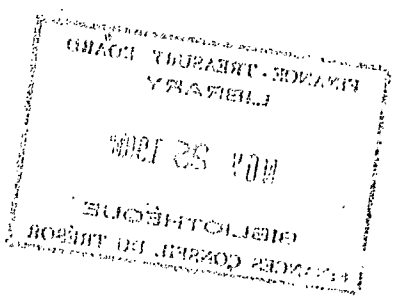

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Introduction

Since the taxation of capital gains was introduced in Canada in 1972, it has been the subject of much discussion. Concerns have been expressed about its impact on the economy. Various proposals for change have been made. These range from complete exemption of capital gains, to exemption for particular types of capital gains such as gains on the sale of shares of public companies, to moving from their present half-taxation to full taxation.

The purpose of this paper is to review the role of capital gains in the tax system, to compare Canada's treatment of capital gains with that of other industrialized countries, to present general information on the Canadian experience since 1972, and to discuss various issues associated with the taxation of capital gains. Taxation of capital gains affects the equity and stability of the tax system and is an important source of government revenue. Because the taxation of capital gains is interwoven with many other provisions of the Income Tax Act, any major change in their tax treatment would require a restructuring of the whole tax system. It is thus crucial that the desirability of any modifications to the tax treatment of capital gains be carefully reviewed and discussed.

Capital Gains and Why They are Taxed

Definition of Capital Gains

The essence of any capital gain is the sale of a capital property for more than its original purchase price plus any costs of selling and buying and costs of improving the property during the time it is held. Capital property includes both tangible property such as land, buildings, machinery and equipment and works of art, and financial assets such as shares, bonds and other securities.

While in concept it may be easy to define capital gains, in practice, differentiation between capital gains and other types of income is fraught with difficulties. Capital gains arise in transactions involving capital property. No precise line can, however, be drawn as to whether a particular asset is or is not a capital property. For example, the sale of real estate by an individual would ordinarily be a capital transaction giving rise to a capital gain. However, the same property, if sold by a real estate firm, would not give rise to a capital gain but ordinary business income since such a sale would be part of its normal business activity, no different from purchases or sales of other goods by business firms in general which give rise to business income. Similarly, purchases and sales of shares and bonds by security dealers are considered to be ordinary business transactions and thus do not give rise to capital gains.

Whether a particular transaction or series of transactions is business activity or not will depend on such factors as the frequency of similar transactions and the motives for and nature of the sale -- whether it was unanticipated, so that the return was more of a windfall gain than business income. Of course, such factors matter only if the tax treatment of capital gains differs from that of business income, which is the case in Canada where only half of capital gains are included in income subject to tax.

The Income Tax Act and jurisprudence have established a number of circumstances where increases in the value of an asset are considered to be ordinary income when realized. Any gains associated with buying and reselling inventory are treated as business income. Certain assets, such as resource properties, are deemed not to be capital property so that increases in their value are fully taxed as income when realized. The courts have held over the years that where an investment is made for the purpose of providing income, such as interest or rent, any profit on the sale of the property will be a capital gain, whereas if the primary motive of the investment is to benefit from an increase in the value of property, the investor may be regarded as speculating and the profit therefrom would be treated as ordinary income. A gain is also more likely to be considered business income when the property disposed of is related to the taxpayer's ordinary business.

As the dividing line between capital transactions and business transactions is very often unclear, the difference in tax treatment between the two provides an incentive for taxpayers to organize their affairs so that income appears as a capital gain. Historically, since capital gains have been taxed less heavily than other forms of income under the

Canadian tax system, it is not surprising that these matters have given rise to considerable litigation.

Another major source of difficulty in determining capital gains relates to the fact that appreciation in the value of assets occurs for a number of reasons. On the one hand changing market conditions (due, for example, to changes in incomes or investor expectations or to scarcity of the product) will lead to changes in the values of capital properties. The resulting capital gains can be considered the classic type. Examples include increases in stock prices due to heightened expectations about future corporate performance, and increases in land prices around an expanding city.

On the other hand the appreciation may represent accumulation or accrual of other forms of income, which is then realized on disposal of the property. For example, the appreciation in the value of a bond may represent not only a genuine increase in its value due to market forces but also the value of any accrued but unrealized interest income. If the true capital gain and the interest income are to be treated differently for tax purposes, rules are required to isolate the two components of the sale price.

Similarly, appreciation in the value of a corporate stock may represent accumulation of business profits in the corporation. In many circumstances taxpayers have a choice of realizing this accumulation either as a dividend if the profits are distributed or as a capital gain if the profits are retained and realized indirectly by the shareholder in the price received on the sale of his shares. As long as there are differences in the tax treatment of dividends and capital gains, taxpayers will attempt to structure transactions in order to convert one to the other. Such conversions may take many forms, particularly in the case of closely-held private companies.

Any preferential tax treatment of capital gains requires extensive rules to distinguish them from other forms of income. These rules, by their very nature, tend to be complicated and frequently arbitrary. History and experience with the Canadian tax system provide ample evidence of the difficulties in drawing such distinctions.

One other aspect of the definition of capital gains deserves mention. In public discussions, capital gains, unlike other forms of income, tend to be uniquely regarded as a reward for risk-taking. It is, however, inappropriate to state that all capital gains are a reward for high-risk investments. While risky investments may give rise to capital gains, for tax purposes capital gains are conventionally defined as the profit realized on the sale of *any* capital property, not all of which have the same degree of risk associated with them. For example, holdings of real estate, which are a major source of capital gains, are very often subject to much less uncertainty than are investments in venture enterprises or many small business operations. Clearly, the degree of risk varies from investment to investment, and many investments yielding business income are subject to higher risk than other investments expected to yield capital gains. The relationship between capital gains and the degree of risk-taking is thus quite imprecise.

Why Capital Gains are Taxed

An extensive review of the tax system occurred in the 1960s beginning with the establishment of the Royal Commission on Taxation in 1962 and culminating in major changes in individual and corporate income taxes, including taxation of capital gains, which took effect from January 1, 1972. The tax treatment of capital gains was a major topic of discussion and debate in this review. The Royal Commission recommended that capital gains be fully taxable as are other forms of income which add to a person's power

to command goods and services. The main arguments advanced then for the taxation of capital gains, which continue to be relevant, are as set out below.

An effective self-assessing system must be seen to be fair and equitable; taxpayers must believe that the system is levying taxes on a reasonable basis and that the distribution of taxes is equitable. There are two dimensions to this, and the tax treatment of capital gains has an important bearing on both. First, in a tax system based on ability to pay, all sources of income which increase the economic power of the recipient, including capital gains, should be recognized in determining the tax base. An individual who realizes a $100 gain has the same increased spending and saving alternatives as another person who receives an additional $100 in his paycheque. This principle was upheld by the Royal Commission (the Carter Report) and was given popular expression as "a buck is a buck". Comprehensive taxation would require that all forms of income be fully recognized in determining tax liability, so that those in equivalent positions bear the same level of tax (so-called horizontal equity). If capital gains are not taxed on a par with other income, certain individuals and groups receive preferential tax treatment relative to others who have the same ability to pay.

Second, it has long been accepted in Canada that a tax system based on ability to pay should levy progressively more tax on higher-income taxpayers than those with lower incomes (so-called vertical equity or progressive taxation). Because of the strong concentration of capital gains in higher-income brackets, their tax treatment has an important influence on the progressivity of the tax system. In 1978, for example, the top 1/10th of one per cent of tax filers with incomes above $100,000 accounted for 24.2 per cent of reported capital gains, though their share of total income was only 1.9 per cent. To indicate further the concentration of capital gains, it can be noted that in 1978 some 500 individuals with incomes over $100,000 derived virtually all of their income from capital gains.

Another important reason for the taxation of capital gains is the neutrality of the system. The criterion of neutrality, simply stated, is that taxes should be levied in such a way as to minimize distortions in the working of market forces and in patterns of economic behaviour. Such distortions divert resources from more productive to less productive uses, reduce the efficiency of the economy and, thereby, lower living standards and the potential for economic growth. If one form of return from capital is taxed significantly less than others, there could be misallocation of resources and excessive uneconomic investment in the type of assets most likely to produce this type of return. For example, land and real estate holdings normally yield more of their return in the form of a capital gain. If capital gains receive preferential tax treatment, investment in these assets would, other things remaining the same, be larger than under a neutral tax system. If the aggregate volume of investment remained unchanged, then less funds would be available for investments in assets yielding interest or business profits which are not taxed preferentially.

Non-neutrality also leads to considerable effort and resources being devoted to tax avoidance measures. Pronounced efforts to convert business income into capital gains were made prior to the 1972 tax reform because of the major differential in tax treatment between capital gains and other types of income.

Two further principles for a sound system of taxation are simplicity and certainty. On the one hand, if capital gains were not taxed, the necessity of retaining information to compute gains would be avoided. On the other hand, complex rules would be required to distinguish capital gains from other income and considerable uncertainty would continue to exist about the dividing line in individual cases. As is evident particularly from the

pre-1972 experience in Canada, this distinction would be among the most litigated in the tax system. Certainty would be highest under full taxation of gains because taxpayers would know that whether a transaction yielded capital gains or other income the tax consequences would be identical. There would be no concern as to whether tax authorities and the courts would deem a particular transaction to have given rise to income rather than a capital gain. Nobel laureate economist Paul Samuelson has put the point this way:

> "Old-fashioned tax administrators perpetuate the myth that a capital gains tax leads to administrative headaches. American Treasury and legal experience is just the opposite: It is *hard* to administer an income-tax system if you do not tax capital gains or if you tax them lightly, because then devices multiply to convert ordinary income into the semblance of capital gains."(1)

These were some of the considerations that led the Royal Commission on Taxation to recommend that capital gains be fully taxable as income. In fact, besides recommending full taxation, the commission supported the concept of taxation on an accrual basis, where feasible, in order to ensure uniform tax treatment of all forms of income.

Following the Royal Commission Report, the government published a White Paper in 1969, entitled *Proposals for Tax Reform* which expressed sympathy with the Commission's recommendation for taxation of capital gains as follows:

> "A Canadian who is able to realize a substantial stock market profit or real estate gain clearly has an increased ability to pay; he is better able to pay for a new car, or to pay for stocks and bonds, or to pay income taxes, than is his neighbour who has not had such a gain. At present, Canada does not tax this ability to pay. As a result, some very well-to-do Canadians pay far less tax than others with similar abilities to pay, and less even than others with much lower incomes (all because these particular Canadians receive a large part of their income as 'capital gains'). Moreover, it has been possible for the sophisticated to arrange their transactions in such a way that they receive as capital gains amounts that would have been income had the transaction been carried out in the normal manner."

The 1969 White Paper proposed full taxation of capital gains on a broad range of assets, with the notable exception of gains on shares of widely-held companies. These were to be half-taxable when realized, and 50 per cent of the accrued but unrealized gains on these shares were to be brought into income every five years. The White Paper rationalized half-taxation of capital gains on such shares on grounds of maintaining a balance between the taxation of capital gains and dividends which were to be eligible for the dividend tax credit. Also, half-taxation was to put Canadians in approximately the same tax position regarding capital gains on shares as most of the non-residents who invest in Canada.

Public discussion following the release of both the Carter Report and the White Paper brought forward a number of issues and special considerations regarding the tax treatment of capital gains. In particular, it was argued that the taxation of gains should not be such as to inhibit economic growth. The need for an adequate level of savings for capital investment purposes, the desirability of assuring sufficient risk capital, the adequacy of equity investment and healthy capital markets, and the adjustment for inflation in measuring real capital gains were important issues. In addition, the Eighteenth Report of the Standing Committee on Finance, Trade and Economic Affairs Respecting

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(1) P.A. Samuelson, *Tax Deductibility of Economic Depreciation to Ensure Invariant Valuation*, Journal of Political Economy, December 1964, p. 606.

the White Paper on Tax Reform spoke in 1970 of the need for "taxpayer understanding and acceptance" in presenting their proposal for half-taxation of gains.

The treatment of capital gains eventually adopted in 1972 reflected these diverse concerns. Only one-half of capital gains were to be included with income. This compromise responded to the basic rationale for inclusion of capital gains in income based on the concept of equity, while recognizing the other considerations involved. Other important changes related to the inclusion of capital gains in income were made at the same time. For example, the federal government withdrew from the estate and gift tax field. The top marginal rates of personal income tax were reduced substantially, since the inclusion of capital gains in income broadened the tax base for higher-income taxpayers.

Current Tax Treatment of Capital Gains and Their Significance

There has now been more than seven years' experience with the taxation of capital gains in Canada. In order to provide an indication of the importance of capital gains, this section briefly outlines their current tax treatment and presents empirical information on their volume, revenues from their taxation, and their distribution among taxpayers.

Current Tax Provisions

Generally, one-half of capital gains of individuals and corporations are included in income for tax purposes and subject to tax at the normal personal or corporate rates. While it is common to hear references to a "capital gains tax", this is not really an accurate description as there is no separate tax on capital gains. Capital gains are simply another income source, one-half of which is included with income from other sources in determining taxable income on which a person's tax liability is based.

One-half of capital losses (called allowable capital losses) are generally deductible against taxable capital gains realized in the year. Individual taxpayers may also deduct each year up to $2,000 of allowable capital losses from income from other sources. Unused allowable capital losses may be carried back one year and forward indefinitely to be offset against taxable capital gains and, in the case of individuals, against up to $2,000 of other income. One-half of capital losses on shares or debt of small business corporations may be deducted against other income, without limit, by both individual and corporate investors.

Capital gains that accrued before the end of 1971 are not subject to tax. Taxable capital gains and allowable capital losses are generally recognized for tax purposes only when realized, that is, in the taxation year in which disposition of the property occurs. The gain (or loss) will usually have accrued over a number of years, so that tax on any accrued gain is deferred until the gain is realized.

A taxpayer is deemed to have disposed of capital properties at fair market value at death or when a gift is made. Any taxable capital gains from such deemed disposition are included in the taxpayer's income for that year. A deemed disposition also occurs in certain circumstances when a person ceases to be a Canadian resident.

Gains on the sale of a principal residence are exempt from tax. Exemption also applies to gains on certain cultural properties sold or transferred to an institution or a public authority in Canada and to gains from the disposition, for $1,000 or less, of "personal use" property such as automobiles, boats or artwork. Where personal use property costing less than $1,000 is disposed of for an amount exceeding $1,000, the property is deemed to have cost $1,000. Lottery winnings and similar prizes are also exempt from tax.

Capital gains of individuals from the disposition of Canadian securities (basically, shares or debt of Canadian corporations) qualify, along with interest and dividend income, for a deduction of up to $1,000 of investment income.

The Income Tax Act contains a number of provisions which give opportunity to defer the recognition of gains in specified circumstances. Deferrals, often referred to as "rollovers", are permitted under the following circumstances, among others:

when a property is transfered to a spouse, whether during life or on death;

when certain farm property, or shares of a family farm corporation, are transferred to children or grandchildren;

on gains of up to $200,000, when shares of small business corporations are transferred to children or grandchildren;

when business or farming property is sold and the proceeds are used to acquire another property for similar use; and

on any gains arising on exchanges of property in certain business and corporate reorganizations. (These are described more fully in Appendix I.)

In all of these cases, the tax is deferred until the property is subsequently disposed of in taxable circumstances.

The Income Tax Act provides that the taxation of capital gains may be averaged over a number of years by the purchase of an income-averaging annuity contract. The taxation of the capital gain is thereby spread over the term of the annuity, and the gain does not serve to push the taxpayer into a significantly higher tax bracket, as could occur if all of it were taxable in the year of disposition. In addition, where not all the proceeds of disposition of a property are immediately receivable, only a portion of the gain may be taxable in the year. The remaining portion can be deferred until the proceeds are received. This would occur, for example, when farmland or shares of a private company are sold and the sale price is received in instalments.

It is important to note that deferrals of tax through the various provisions noted above serve to reduce the effective rate of tax on capital gains. In the case where tax on a gain can be deferred for five years, assuming a discount rate of 10 per cent per annum, the deferral benefit, plus the benefit of half-taxation, are equivalent to exempting some 69 per cent of the gain (and taxing the remainder immediately with no deferral). At this same discount rate a deferral of tax for 25 years or longer is tantamount to a complete exemption of gains from tax, as the present discounted value of the tax due 25 years hence is negligible. Or, to put it differently, a deferral is equivalent to the government collecting the tax when due and then immediately giving an interest-free loan to the taxpayer of an amount equal to the tax collected. At an asumed interest rate of 10 per cent, the benefit accruing to a taxpayer from an interest free loan for a 25-year period is almost equal to his current tax liability on capital gains.

Amount of Reported Capital Gains

Capital gains have given rise to significant amounts of income for tax purposes, particularly in recent years.

Table 1 presents the total capital gains and losses, before one-half exclusion, reported by individual taxpayers (columns 1 and 2), their net taxable gains (column 3), i.e., one-half of gains less losses and the net taxable capital gains of corporations, i.e., one-half the

Table 1

Capital Gains and Losses Reported for Income Tax Purposes, 1972-1978

	Individuals			Corporations	
	Total Capital Gains	Total Capital Losses	Net Taxable Gains	Net Taxable Gains	Total Net Capital Gains
	(1)	(2)	(3)	(4)	(5)
			($ millions)		
1972	351.9	162.6	149.0	89.5	368.4
1973	586.2	293.0	245.4	185.8	664.0
1974	731.8	506.2	282.5	223.6	672.8
1975	1,065.3	409.7	404.5	323.8	1,295.1
1976	1,592.8	376.7	632.2	409.5	2,035.0
1977	1,851.3	400.8	773.2	519.6	2,489.5
1978	2,775.9	368.7	1,193.3	795.0*	3,977.2

Notes:
Figures for total capital gains and for total capital losses are not all-inclusive since they are based on net figures reported in tax returns of individuals. They do not include gains deducted by persons reporting net capital losses, or losses deducted by persons reporting net capital gains.
Net taxable gains are one-half of gains less one-half of losses as limited by the $1,000 ($2,000 commencing in 1977) of allowable losses that may be offset against other income and less net additions to reserves for sales proceeds due in later years.
Gains and losses are not reported separately for corporations. The net taxable gains of a corporation are one-half of the excess of capital gains over capital losses. For corporations with losses in excess of gains, there will be a carry-forward to future years. Losses available for carry-forward are not included in the corporate values presented.
Total net capital gains of individuals and corporations are calculated as total capital gains less losses of individuals (Columns 1 and 2) plus twice the net taxable capital gains of corporations.
* Based on preliminary information.
Sources: Revenue Canada, *Taxation Statistics*; Statistics Canada, *Corporation Taxation Statistics* (61-208).

excess of capital gains over losses for each corporation. Total net capital gains (total gains net of losses, before one-half exclusion) reported by individuals and corporations in 1978 were over $3.9 billion.

The table shows a rapid growth in capital gains since they began to be reported for tax purposes in 1972. Total gains reported by individuals (column 1) increased on average by some 40 per cent annually from 1972 to 1978. One important factor behind this growth is the maturing of the taxation of capital gains. Under a mature system, the full amount of the increase in the value of each capital property disposed of in the year over its original purchase price would be recognized for tax purposes. However, in the early years of taxation of capital gains, a substantial portion of such increase was excluded from tax since only the portion of gain accruing after 1971 was recognized for tax purposes. Over time, the proportion of properties acquired after 1971 increases, as does the proportion of gains accruing after that date. Thus the amount of gains reported has been growing rapidly as a natural result of the maturing process. It is only in the last one or two years that the amount of gains reported (and government revenues) bears a reasonable relationship to the expected values in the future.

Losses have not grown as rapidly as gains over this period. This is to a large extent a reflection of stock market performance in that the peak year for losses, 1974, was a poor

year in the market. It may also be due to the differences in the timing of realization of accrued gains and losses.

Table 2 shows the net capital gains of individual taxpayers for the major categories of capital property for the years 1972 to 1978. The distribution of net capital gains for corporations is available only for 1977 and is given in the footnotes to the table. With the exception of the first two years, the dominant source of capital gains for individuals and corporations has been real estate. In 1978, 53 per cent of net capital gains of individuals were derived from sales of real estate and 34 per cent from sales of shares. For corporations in 1977, the proportions were 68 per cent and 16 per cent respectively.

Table 2

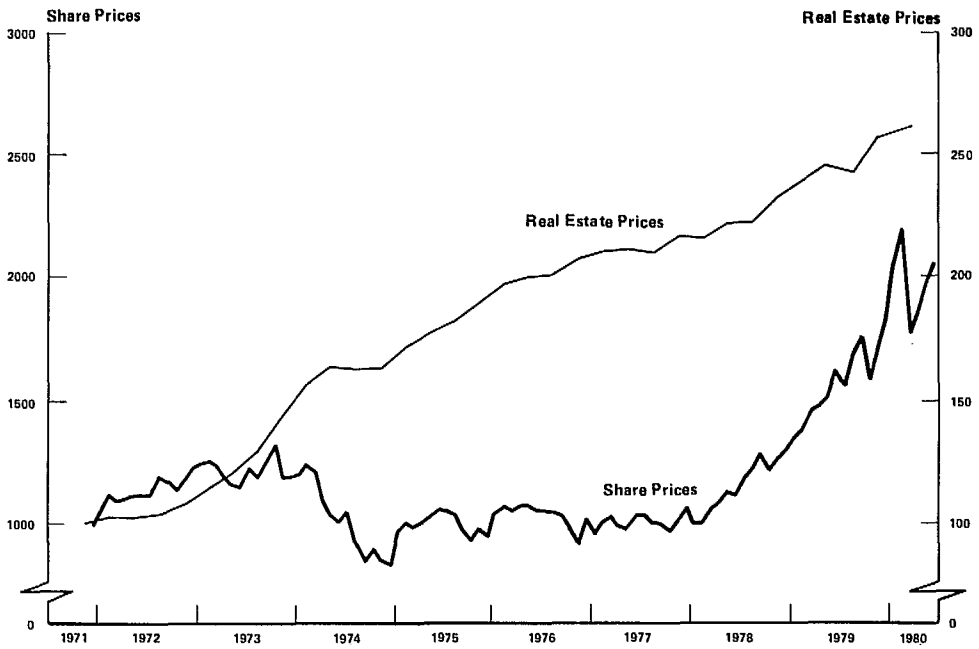
Net Capital Gains or Losses on Various Types of Capital Property, 1972-1978[1]

	Individuals					Corporations[4,5]	Total
	Shares	Real Estate	Bonds or Other Properties	Other[2]	Total[3]		
				($ millions)			
1972	194.8	−21.7	−6.5	22.8	189.4	179.0	368.4
1973	167.1	100.8	−8.1	32.6	292.4	371.6	664.0
1974	−177.0	393.5	−19.6	28.7	225.6	447.2	672.8
1975	−38.7	661.4	−9.1	41.9	655.5	639.6	1,295.1
1976	197.4	952.8	17.7	48.1	1,216.0	819.0	2,035.0
1977[6]	338.8	1,038.6	18.6	54.4	1,450.4	1,039.2	2,489.6
1978	810.8	1,259.9	74.3	242.2	2,387.2	1,590.0[7]	3,977.2

(1) Net capital gains or losses are the difference between the realized capital gains and realized capital losses for each category of property.
(2) "Other" includes gains on personal property and listed personal property, gains allocated to individuals by employees' profit-sharing plans and by trusts and cash bonus payments on Canada Savings Bonds reported as capital gains. The large increase in this type of gain in 1978 was due mainly to cash bonus payments on Canada Savings Bonds which became payable in that year. These bonus payments could be reported as capital gains or interest at the option of the taxpayer.
(3) The total net capital gains are equal to the difference between total capital gains and total capital losses for individuals as shown in Table 1 except for differences due to rounding.
(4) Net capital gains of corporations are the excess of gains over losses before the subtraction of the one-half of gains which are tax-exempt. The net capital gains of corporations are equal to twice the net taxable gains of corporations as shown in Table 1.
(5) The net capital gains of corporations by type of capital property are available only for 1977. The estimated distribution is: shares (15.7 per cent); real estate (67.6 per cent); bonds or other property (16.6 per cent); and other (0.1 per cent).
(6) For 1977, Table 18 of Revenue Canada, *Taxation Statistics*, does not reflect gains and losses on Canadian shares ($238.3 million), Canadian bonds (-$16.1 million) and certain other gains ($22.2 million). These have been added in the above table to make the reported values complete and consistent with other years.
(7) Based on preliminary information.
Sources: Revenue Canada, *Taxation Statistics*; Revenue Canada, *Preliminary Taxation Statistics*, 1978 Taxation Year; Statistics Canada, *Corporation Taxation Statistics* (61-208); and unpublished information from Revenue Canada and Statistics Canada for 1977 and 1978.

These relative proportions are, of course, a reflection of the real estate and stock market performance over recent years as depicted in Chart 1. As is evident from the chart,

SHARE AND REAL ESTATE PRICES
1971 - 1980



Sources: Share prices: The price series used is the Toronto Stock Exchange Composite Index of 300 shares. The values shown are monthly closing quotations commencing in December, 1971 and ending June, 1980.

Real Estate Prices: The price series used is the average dollar value of multiple listing service transactions compiled by the Canadian Real Estate Board. The values shown are quarterly averages commencing in the Final Quarter 1971 and ending in the First Quarter 1980. (4th quarter of 1971 equals 100.)

it was only after 1977 that share prices moved sharply above their 1971 level. This upturn in the stock market is reflected in the significant increase in the ratio of share gains to total gains for individuals, from 23 per cent in 1977 to 34 per cent in 1978. The portion of gains related to dispositions of shares is expected to be still higher in 1979, given the market performance during that year.

Revenue from Taxation of Capital Gains

Table 3 shows the estimated revenues derived by federal and provincial governments from the inclusion of capital gains in income for tax purposes. Federal revenues in 1978, the latest year for which detailed actual data are available, amounted to $450 million, some 1.3 per cent of total federal budgetary tax revenues in that year. (2) Provincial revenues from this source were $200 million in 1978. The revenues from the taxation of capital

(2) It is frequently asserted in public discussions that revenues from taxation of capital gains are less than the cost of their collection by the government. This is not the case. The federal revenues from tax on capital gains in 1978 were some 25 per cent higher than the entire program expenditures of Revenue Canada Taxation for administering the federal and provincial Income Tax Acts, and for collecting contributions to the Unemployment Insurance Plan and the Canada Pension Plan.

Table 3

Estimates Federal and Provincial Revenues from Taxation of Capital Gains(1)

	Taxation Year						
	1972	1973	1974	1975	1976	1977	1978
	($ millions)						
Federal							
Individuals	40	70	80	100	150	175	260
Corporations	30	60	70	95	125	145	190
Total	70	130	150	195	275	320	450
Provincial							
Individuals	14	24	27	35	55	90	130
Corporations	12	24	28	38	50	55	70
Total	26	48	55	73	105	145	200
Total Federal and Provincial Revenues	96	178	205	268	380	465	650

(1) The estimates are the additional revenue gain attributable to the inclusion of capital gains in income for tax purposes. They are thus based on the marginal tax rate for this income source. *Source*: Simulations with the Personal Income Tax Micro-simulation Model; Statistics Canada, *Corporate Taxation Statistics*; and preliminary data from Revenue Canada on 1978 corporate tax returns.

gains have been growing rapidly, in part due to the maturing of the structure, as described above.

These values indicate only what the direct impact of eliminating taxation of capital gains would have been in the various years. But any reduction in tax rates on capital gains would undoubtedly lead taxpayers to rearrange their affairs to obtain more of the return on their investments in the form of capital gains, so the eventual revenue cost would be larger than the estimates in Table 3. Taking account of the growth in revenues from this source over the recent past, the improved stock market performance since 1977, and the impact of the behavioural changes that would occur, it is estimated that the reduction in federal revenues in 1980 from elimination of tax on capital gains would be in excess of $750 million. Adding the associated provincial revenue loss would bring the total to over $1 billion.

Distribution of Capital Gains By Income Level

As noted previously, the taxation of capital gains has an important influence on the equity of the overall tax system. Table 4 provides information on the distribution of

capital gains, and the revenues from their taxation, by income class for the 1978 taxation year. The main observations are as follows:

Higher-income taxpayers account for a disproportionate share of capital gains. For example, taxpayers earning more than $50,000, who accounted for only 0.8 per cent of the taxpayer population, received over 40 per cent of total net taxable capital gains.

The high concentration of capital gains in upper-income brackets is also reflected in the percentage distribution of tax revenues by income class. Taxpayers with income above $50,000 accounted for over one-half of federal revenues from taxation of capital gains.

The proportion of individuals reporting capital gains increases sharply with income, as does the amount of average gain. For example, less than 4 per cent of filers with incomes below $15,000 reported capital gains, while over 40 per cent of those in the over $100,000 income class reported capital gains. The average amount of gain reported increases from about $2,000 in the lower income ranges to over $77,000 in the top income class.

Table 4

Distribution of Federal Tax on Capital Gains by Income Class, Individuals, 1978 Taxation Year

Assessed Income Class	Share in Taxfiler Population	Share in Total Income	Share in Net Taxable Capital Gains	Share in Federal Tax on Capital Gains	Filers Reporting Gains	
					As a Percent of All Filers in the Class	Average Gain
($)						($)
Under 5,000	32.3	5.8	3.0	–	1.2	1,700
5,000 – 15,000	40.8	35.7	15.4	6.1	3.7	2,100
15,000 – 25,000	19.8	34.3	14.9	12.2	5.6	2,700
25,000 – 50,000	6.3	18.1	24.0	27.5	14.6	5,200
50,000 – 100,000	0.7	4.2	18.5	23.8	29.9	16,100
100,000	0.1	1.9	24.2	30.4	44.4	77,100
Total	100.0	100.0	100.0	100.0	2.3	6,500

Source: Simulations with the Personal Income Tax Micro-simulation Model, and Revenue Canada, *Taxation Statistics*

International Comparison of Taxation of Capital Gains

General Comparison

In any evaluation of the Canadian tax treatment of capital gains, it is important to compare Canada's system with those of other industrialized countries. Tables 5A and 5B outline the major features of the treatment of capital gains of individuals and unincorporated businesses in a number of OECD (Organization for Economic Cooperation and Development) countries. Taxation of capital gains of corporations is discussed separately below. Because of significant variations in the tax treatment of capital gains at the state, provincial or local levels within a country, the comparison is, by necessity, confined to the treatment at the federal level. This, however, does not affect the basic conclusions reached here, unless otherwise indicated.

Over all, Canada's tax treatment of capital gains is not out of line with that in other countries. In fact, the combined burden of estate, wealth, gift and capital gains taxes is lower in Canada than in other countries surveyed. The following points deserve note:

Canada taxes capital gains of both individuals and businesses through the income tax system. This approach is also followed by the United States, Japan, France, Norway and Sweden. The United Kingdom, Ireland, and Denmark have separate capital gains taxes. Taxation of capital gains in West Germany, Italy and several other countries is less comprehensive, being restricted to businesses, although some short-term gains of individuals are taxed in full as income. Australia taxes only certain short-term capital gains and these are treated as ordinary income.

Canada's rates of tax on capital gains are lower than in many other countries. Canada's maximum effective federal tax rate on short-term gains is generally lower than in other countries that tax capital gains. On long-term gains, Canada's maximum federal tax rate is below that in the U.S., the U.K., Japan (on real estate and substantial shareholdings only), Sweden and Ireland, and is lower than rates on real estate gains in a range of other countries. Even the combined federal and provincial tax rates in Canada are generally lower than, or comparable to, the central government rates in these countries.

In Canada, gains on the sale of a principal residence are unconditionally exempt. While this approach is followed in a number of countries, there are notable exceptions; in West Germany, for example, they are fully taxable if the residence is sold within two years of acquisition.

Gains on shares and bonds are taxable in Canada, as is the case in a good number of other countries. *Even in countries where they are exempt, speculative gains, short-term gains, and gains on significant holdings (as would usually be the case for a shareholder of a private company) are often fully taxable.*

Table 5(A)

Summary of Tax Treatment of Capital Gains of Individuals
Selected OECD Countries, 1980

	Taxation of Capital Gains	Tax on: A. Estate/ Inheritance B. Wealth	Tax Treatment of Capital Gains on Various Assets				
			Shares		Bonds		Principal Residence
			Short-term	Long-term	Short-term	Long-term	
Canada	General	A. No B. No	One-half taxed as income		One-half taxed as income		E
United States	General	A. Yes B. No	Fully taxable as income[1]	40 per cent taxed as income	Fully taxable as income[1]	40 per cent taxed as income	Deferral if reinvested with fixed exemption for those over age 55[2]
United Kingdom	General	A. Yes B. No	Separate 30-per-cent tax with partial tapering[3]				E
Japan	Partial	A. Yes B. No	Speculative gains and significant holdings taxed[4]		Speculative gains taxed		E
West Germany	Partial	A. Yes B. Yes	Fully taxed as income[5]	E[5]	Fully taxed as income	E	Short-term gains taxed[5]
France	Partial	A. Yes B. No	Taxable with exemption for small transactions[6]				E
Norway	Partial	A. Yes B. Yes	Separate 50-per-cent tax[7]	E	E	E	E
Portugal	Partial	A. Yes B. No	Certain gains taxed at 10-per-cent rate[8]		E	E	E
Belgium	None	A. Yes B. Yes	E	E	E	E	E
Denmark	Partial	A. Yes B. Yes	Fully taxed as income[9]	E	E	E	E
Ireland	General	A. Yes B. No	Separate 30-per-cent tax with reduced rates for longer holding periods				E
Italy	Very limited[10]	A. Yes B. No	E	E	E	E	E
Spain	General	A. Yes B. Yes[11]	Taxed fully as income with reduced rates depending on holding period				E
Sweden	General	A. Yes B. Yes	Fully taxed as income[11]	40 per cent of gain taxed as income	Fully taxed as income[12]	Reduced rates[13]	E
Austria	Partial	A. Yes B. Yes	Speculative transactions taxed as income[14]	E[14]	Speculative transactions taxed as income[14]	E[14]	E
Australia	Partial	A. Yes B. No	Fully taxed as income[15]	E	Fully taxed as income[15]	E	E
Netherlands	Partial[16]	A. Yes B. Yes	Speculative gains and gains on shares which are a substantial interest taxed		Speculative gains taxed		E

GENERAL NOTES: Tables 5(A) and 5(B)

- E indicates exemption.
- In countries where gains on either shares or bonds are generally exempt, they are generally taxable if they are part of the business assets of the individual selling the asset. As well, countries with partial or limited taxation generally tax real property gains.
- Countries with partial taxation generally tax gains on shares and bonds if they are part of the business assets of the seller, and also tax gains on real property.
- All dollar amounts in the table are in the approximate Canadian dollar equivalent of national currencies.

SOURCE: Information compiled from Guides to European Taxation (International Bureau of Fiscal Documentation), Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals (Report of the Committee on Fiscal Affairs of the OECD).

NOTES: Table 5(A)

(1) In the United States gains on assets held under one year are short-term.

(2) In the United States tax on gains on principal residences is deferred as long as proceeds are reinvested in a home. When taxpayer reaches age 55, up to $116,000 of gains on home are exempt.

(3) In the United Kingdom a reduced rate of 15 per cent applies to gains of between $2,750 and $13,750. Tapering relief applies to gains of between $13,750 and $26,125.

(4) Japan also taxes gains on certain large transactions.

(5) West Germany also taxes gains on shares where shareholder has a substantial interest in a company (more than 25 per cent of its share capital). These gains are taxed at one-half the rate on ordinary income. Gains on principal residences are fully taxable if sale occurs within two years of acquisition.

(6) France taxes gains on shares and bonds in various circumstances. Transactions with borrowed money, and other transactions where total annual amount exceeds 1.6 times value of securities owned and sales exceed $28,000 are taxable at 30 per cent. Other transactions totalling more than $42,000 are taxed at 15 per cent. Where shareholder has a substantial interest share gains are taxable at 15 per cent.

(7) In Norway gains realized within two years are short-term. Gains from sale of a substantial portion of a corporation's shares are taxed as ordinary income.

(8) Portugal imposes a separate 10-per-cent tax on one-half the increase in capitalized reserves of companies and one-half the difference between value and issue price of new shares issued to existing stockholders. This tax is payable by the company which must recoup it from shareholders.

(9) In Denmark gains realized within two years are short-term. Certain "extraordinary gains" are also taxed at a rate of 50 per cent.

(10) Italy taxes gains on shares and bonds if the holder engages in "speculative transactions", in which case they are taxed in full as income.

(11) Spain's net wealth tax was introduced as a temporary measure.

(12) Short-term gains in Sweden are those on assets held for less than two years.

(13) In Sweden, on bonds held for two years or more, only a portion of the gain is taxed as income, as follows:
- bonds held between 2 and 3 years: 75 per cent of gain taxed;
- bonds held between 3 and 4 years: 50 per cent of gain taxed;
- bonds held between 4 and 5 years: 25 per cent of gain taxed;
- bonds held 5 years or more: no tax on gain.

(14) In Austria short-term transactions are speculative transactions with sale within one year from date of purchase. Gains on shares of a corporation in which a taxpayer has a substantial interest are taxed at half the normal tax rates.

(15) Short-term gains in Australia are those on sales within one year of acquisition.

(16) In the Netherlands, gains on shares of a company in which the shareholder has a substantial interest are taxed at 20 per cent. Gains on shares or bonds which are regular speculative gains are fully taxed as income. Certain other gains are also taxed such as on liquidation of a company or on sales of shares back to the corporation itself.

Table 5(B)

Additional Features of Taxation of Capital Gains, Individuals
Selected OECD Countries, 1980

	Averaging Provisions	Deductibility of Losses	Treatment of Gains Accrued at Death	Other Features
Canada	Special forward averaging through income-averaging annuities	Against gains and up to $2,000 of other income (unlimited for small business shares and bonds); indefinite carry-forward, one year carry-back	Taxable with deferral for transfers to spouse and for inter-generational transfers of farms and small businesses	First $1,000 of investment income, including gains, exempt
United States	None	Against gains and up to $3,480 of other income; indefinite carry-forward, no carry-back	Exempt prior to 1979, deferral since then	Minimum tax on exempt portion of long-term gains
United Kingdom	None	Against gains only; indefinite carry-forward, three-year carry-back at death	Exempt	Exemption for first $2,750 of gains
Japan	None	Against gains and other income; three-year carry-forward	Deferred	Exemption for first $2,600 of gains
West Germany		Against gains in same year only	Exempt	First $650 of speculative gain exempt
France	None	Against gains in same year only		
Ireland	None	Against gains; indefinite carry-forward	Deferred	First $1,200 of gains exempt
Spain	Reduced rate system acts as averaging device for assets held for several years(1)	Against gains	Taxable	
Sweden	None	Against gains; six-year carry-forward	Deferred	First $280 of long-term gains exempt

For General Notes and Source references see Table 5(A).

NOTE: Table 5(B)
(1) In Spain, depending on the holding period a reduced tax rate applies. For example, if an asset is held for five years only one-fifth of gain is added to income. The average tax rate on total income (including this portion of gain) is then applied to remaining four-fifths of gain.

One important aspect of the taxation of capital gains is the degree to which they may be averaged over a longer period so as to reduce or defer tax. As noted earlier, tax deferrals or averaging provisions can result in a substantial reduction in the effective rate of tax on capital gains. In this regard, Canada's tax treatment is the most favourable to taxpayers among all the countries surveyed. In addition to the general automatic averaging provision of the individual income tax system, individual taxpayers in Canada are permitted to spread the tax on capital gains over a number of years through the purchase of an income-averaging annuity contract. In comparison, few other countries provide for any form of general averaging at all and in these cases the provisions are less generous than in Canada. Besides Canada, only Spain has special averaging provisions for capital gains.

For capital losses, the general rule among the countries surveyed is that, where gains are taxable, losses are deductible. Where capital gains are not fully taxed as income, losses are usually deductible only against capital gains. Canada follows this general pattern, but also permits allowable losses of up to $2,000 to be deductible against other income; no limit applies in the case of losses on small business debt and shares. In addition, Canada allows for an indefinite carry-forward and a one-year carry-back of losses, while in other countries the carry-forward is often restricted to a certain number of years.

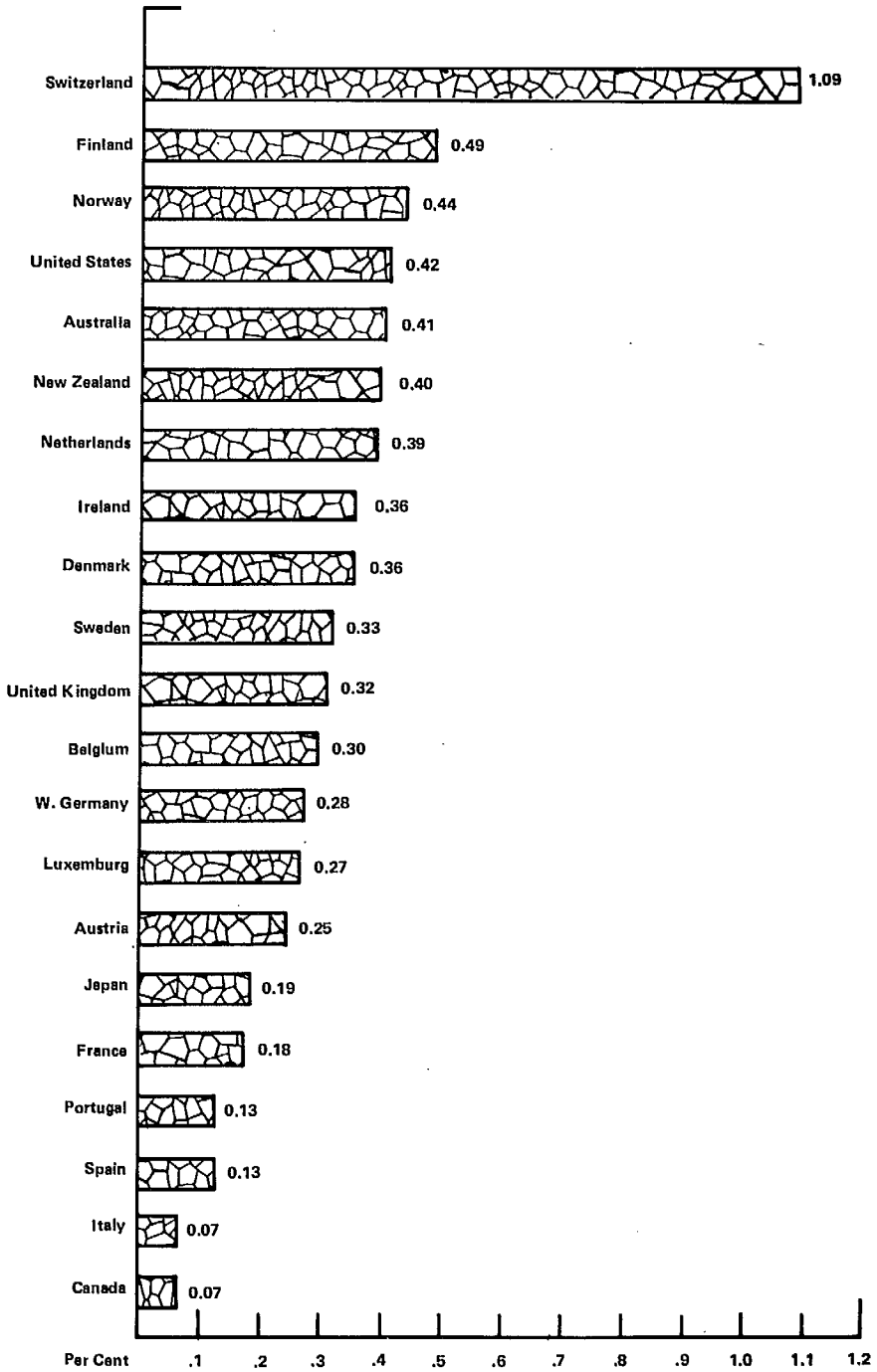
Canada taxes gains accrued at the time of death of the taxpayer as if these gains had been realized. Other countries either defer tax liability until the gain is actually realized on these assets, or exempt accrued gains altogether at the time of death of the taxpayer. However, all these countries have an estate tax and some also levy wealth taxes, whereas Canada has no federal estate or inheritance tax and only one province currently levies succession duties. In aggregate, the burden of estate or inheritance taxes is generally much higher than that of capital gains taxation on death.

As a result of the absence of inheritance and gift taxes at the federal level and in most provinces, Canada's taxation of inheritances, gifts and annual net wealth is the lowest among major industrialized countries. This is illustrated in Chart 2 which shows revenues in 1976 of all levels of government from wealth, estate, inheritance, or gift taxes in 21 OECD countries, expressed as a percentage of each country's gross domestic product.

It is often suggested that the taxation of capital gains at death or when property is gifted was meant to be a substitute for the estate and gift tax that the federal government imposed until 1972. A comparison of tax revenues under the two systems suggests that this has not been the case. For example, federal tax arising from deemed realization of capital gains at death amounted to some $11 million in 1978. In contrast, in 1971 the federal estate and gift tax revenues were over $100 million (equivalent to some $175 million in 1978 dollars). A major reason for this difference is that estate taxes fall on the full value of assets transferred and not just on the increase in value. Also, the base for revenues from the taxation of accrued capital gains at death has been eroded by the tax deferral on inter-generational transfers of farm property and small business shares.

Whatever the reasons, Canada's ranking among OECD countries, as shown in Chart 2, should be an important consideration in evaluating any further reductions in taxes on capital income. Canada's extreme position may already be a cause of concern to the extent that it restricts the government's ability to promote a fair and equitable distribution of income and wealth in the country.

REVENUE FROM TAXES ON INHERITANCES, GIFTS AND ANNUAL NET WEALTH
AS A PERCENTAGE OF GROSS DOMESTIC PRODUCTS, VARIOUS OECD MEMBER CONTRIES; 1976



Source: Revenue Stetistics of OECD Member Countries, 1976

The discussion above relates to the treatment of capital gains in the hands of individuals. Table 6 provides a very general description of the treatment of capital gains of corporations in selected OECD countries. While the treatment of individual assets in particular circumstances differs significantly from country to country, the table does confirm the relative

generosity of the Canadian provisions at the corporate level as well. Canada taxes one-half of corporate gains at regular corporate tax rates, whereas a number of other countries tax corporate gains fully as income, or provide an alternative tax rate that is not as favourable to taxpayers as that levied in Canada. It is interesting to note that, unlike Canada, many other countries do not generally tax corporate capital gains in the same manner as individual capital gains. For example, West Germany taxes corporate capital gains fully at standard rates, even though long-term capital gains of individuals are fully exempt. The United States requires full inclusion of gains in corporate income, taxable at a special rate of 26 per cent, while in the case of individuals only 40 per cent of a gain need be included in income.

Table 6

International Comparison of Aspects of Tax Treatment of Corporate Capital Gains, Selected OECD Countries

Canada:	One-half of gains taxed at ordinary corporate tax rates implying an effective federal rate of tax of 18 per cent. Deferral of tax on voluntary and involuntary dispositions if property replaced. Generous rollovers for corporate reorganizations.
United States:	All gains included in income for tax purposes. Taxpayers are given the option of calculating tax on gains at the alternative rate of 28 per cent. Deferral of tax on involuntary dispositions if property is replaced. Some rollovers for corporate reorganizations.
United Kingdom:	Gains subject to tax at the reduced rate of 30 per cent. Deferral if proceeds reinvested in similar assets within three years.
West Germany:	Gains taxable at standard rates as ordinary business income. Deferral of tax on certain gains if reinvested in replacement property.
France:	Short-term gains (on property held for less than two years) are subject to normal corporate income tax. Long-term gains attract the reduced rate of 15 per cent with a further 35-per-cent tax on distribution.
Italy:	Gains on disposal of physical assets attract normal corporate tax and local income tax. Deferral of tax on gains reinvested in fixed depreciable assets within three years.

Comparison with the United States

Many commentators focus most closely on the differences in the tax treatment of capital gains between Canada and the United States. The following points elaborate on the differences in the tax treatment of capital gains in the two countries.

Individuals

Only one-half of gains (whether short-term or long-term) arising since 1971 are taxed in Canada. In the U.S., capital gains have been taxable in one form or another since 1913. While only 40 per cent of long-term gains of individuals (those on assets held over one year) are taxed in the U.S., short-term gains are fully taxed at rates ranging up to 70 per cent, significantly higher than the tax on such gain in Canada.

The U.S. system contains a minimum tax of 10 to 25 per cent on the exempt 60 per cent of long-term capital gains of individuals. As a result, the U.S. federal tax rate on long-term gains could be as high as 43 per cent (70 per cent tax rate on 40 per cent of gains plus 25 per cent on remainder). Canada does not have a tax analogous to the minimum tax, so that the corresponding top Canadian federal tax rate on capital gains is only 21.5 per cent.

Capital gains on principal residences are completely tax-exempt in Canada. In the U.S., for persons under 55, a deferral applies only to the extent that the proceeds are reinvested in another home. For persons over 55, an exemption exists, limited to U.S. $100,000 of gains.

Capital gains in Canada may be invested in income-averaging annuity contracts which permit the tax on the gain to be spread over a number of years. No analogous provision exists in the United States.

In Canada, there is deemed realization of gains at death. A tax deferral is permitted in the case of inter-spousal transfers of any property and inter-generational transfers of shares in small businesses and family farms. Capital gains realized at death in the U.S. were, until lately, completely exempt. At the end of 1979 the exemption was withdrawn and the U.S. now provides a deferral until the property is subsequently disposed of by the heirs. However, the United States imposes an estate tax on property passing on death.

Corporations

Canada's tax treatment of corporate capital gains is more generous, since only one-half of these gains are taxed. U.S. corporations must include all gains in income subject to tax but are allowed an alternative tax rate of 28 per cent on long-term gains. This alternative rate is of no benefit to small businesses. In contrast, the taxation of capital gains received by private corporations in Canada is fully integrated with the personal income tax system, which means that in effect there is no separate taxation of gains at the corporate level. Capital gains of public corporations are subject to combined federal and provincial corporate tax rates of 20 to 25 per cent. Canada also permits various tax-free rollovers, i.e., tax deferrals, on both voluntary and involuntary dispositions of depreciable property when the proceeds are used to purchase replacement property. In the U.S. these rollovers only apply to involuntary dispositions. Rollovers for corporate reorganizations apply in more circumstances in Canada than in the U.S.

The Technical Role of Capital Gains in the Income Tax System

Under the Canadian income tax system, taxes are imposed separately on corporations and individuals. However, the taxation of individuals in their capacity as shareholders interacts with the taxation of corporations. Most notably, individuals receive income from corporations, generally in the form of dividends or capital gains. Rules relating to the treatment of this income establish a link between the corporate and individual tax systems. This is the point where, in effect, the individual and corporate tax systems meet. The rules linking the corporate and personal tax systems establish the degree of integration of the two systems. The provisions of any tax system that establish this link are important as they affect crucially many business and investment decisions. In designing these provisions a number of important policy questions arise. For example, will the individual tax system recognize that corporate-source income has already borne tax and, if so, to what extent? Will the two basic methods of realizing income – dividends and capital gains – be taxed uniformly? What rules will apply when assets with accrued capital gains are transferred from individuals to corporations, or between corporations in a merger or reorganization? It is obvious from these questions that the taxation of capital gains is an integral part of the corporate/shareholder tax system and cannot be isolated from other parts of the tax system. This section discusses the evolution of the rules relating to the taxation of dividends and capital gains in the Canadian corporate/shareholder tax system, and the implications of changes in the taxation of capital gains.

Taxation of Dividends and Capital Gains

Two major objectives have influenced the tax treatment of dividends and capital gains of shareholders. First, it is desirable that there be a degree of uniformity between the tax treatment of income earned directly by an individual and income earned through a corporation and distributed to the individual shareholder. To the extent that such uniformity exists, the corporate and shareholder tax systems are said to be integrated.

Perfect uniformity or integration would avoid discrimination and inequities that bias Canadians in their choice of investments and ways in which business is conducted. Second, if capital gains are to be taxed at preferential rates, it must be recognized that distributions from corporations that are in substance dividends can be easily converted into capital gains. The tax system must recognize and deal with cases of such conversions – so-called "dividend stripping" or "surplus stripping" – where they offend tax equity and constitute tax abuse.

Prior to 1972 capital gains were tax-exempt. Individuals were required to include dividend receipts in their income, but were allowed a tax credit of 20 per cent of dividends in partial recognition of the tax already borne by this income at the corporate level. Under that system, withdrawal of corporate surplus in the form of dividends or capital gains gave rise to widely different tax consequences.

An example can best illustrate the difference. Assume that Mr. A incorporated OPCO with capitalization of $10,000, that the company had earned $80,000 and that its earnings had enjoyed the low corporate tax rate of 21 per cent. Its after-tax earnings were thus $63,200. Assume further that A's marginal tax rate was 50 per cent and that he wished to withdraw the company's after-tax earnings. As one option, A could simply direct OPCO to pay as dividends all of its $63,200 surplus to him. Net of the dividend tax credit, he would have paid individual income tax of approximately $18,960 on the dividends.

Alternatively, in the absence of rules to prohibit the transactions, he could realize the earnings by selling his shares to a newly-incorporated holding company owned by him, Holdco. The sale would give rise to a $63,200 capital gain, all of which would be exempt from tax. OPCO could then be liquidated by either winding-up or amalgamating and its assets could be used by Holdco to pay for the purchase of the OPCO shares from A. This series of transactions is referred to as a surplus strip of the corporation.

Under the pre-1972 system, surplus stripping techniques were counteracted by complex rules which attempted to ensure that the accumulated underlying corporate surplus would, in practice, be taxed at an appropriate rate when it was distributed. These rules proved to be not only very complex and arbitrary but also technically defective.

In 1950, the first of the anti-stripping rules, the "designated surplus" provision, was introduced. It designated the undistributed income of a corporation on hand at the time its control was acquired by another corporation. The rule disallowed the usual tax exemption for intercorporate dividends on the distribution of designated surplus to the controlling corporation. It effectively nullified a number of surplus stripping transactions, such as that described above, which depended on being able to pass the surplus tax-free between corporations. The effect was to impose a tax of approximately 50 per cent on designated surplus distributions and this, combined with the income tax that had already been paid on the profits, resulted in the removal at the corporate level of the tax benefit that the original shareholder sought to achieve.

The designated surplus rules contained some basic defects that made them at the same time relatively easy to circumvent and inappropriate when they applied. For example, these rules imposed the distribution tax on the purchaser rather than on the vendor who was, after all, the person attempting to obtain the surplus tax-free. In addition, the rules did not always properly measure the underlying surplus, nor did they cover acquisitions of less than a controlling interest.

On the other hand, the rules interfered with various legitimate business reorganizations. For example, consider a common case where various business activities were carried on by separate corporations all under the control of a holding company. Liquidation, amalgamation or other reorganization within the corporate group could trigger the designated surplus provisions on any internal distributions arising on or after the reorganization. In contrast, if the operation of the various businesses had been carried on in separate divisions within one corporation, any profits earned in one line of business could be freely transferred for use in another part of the corporation's activities without any tax consequences.

When it became clear that the designated surplus approach was not effective, a "ministerial discretion" provision was introduced in 1963 to contain a groundswell of surplus-stripping developments. In the absence of a reasonable and workable system, this created taxpayer uncertainty, further administrative difficulties and otherwise unnecessary expenditure of time and effort in the planning of business transactions and in the enforcement of the law.

The inability of the government to check surplus stripping abuses was, in fact, the primary impetus for a comprehensive review of the tax system in the early 1960s. It led to the establishment of the Royal Commission on Taxation. While the Commission was given a broad mandate to report on all aspects of the Canadian tax system, tax avoidance through surplus stripping was a primary concern of the government prior to the establishment of the Commission.

The Commission's recommendation for full taxation of capital gains would have solved the surplus stripping problem. This recommendation was, however, not adopted by the government. Instead, the new system put in place in 1972 included half-taxation of capital gains and significant changes in the dividend tax credit mechanism. Shareholders receiving dividends from taxable Canadian corporations were required to "gross-up" the amount of the cash dividend received by one-third and include this amount in their income for tax purposes. They paid tax on the grossed-up amount, but were eligible for a federal and provincial dividend tax credit of roughly 25 per cent of their grossed-up dividends (the credit was roughly equivalent to the amount of the gross-up). This ensured that, with respect to corporations subject to a tax rate of 25 per cent, the combined corporate and personal tax on income earned through the corporation would be roughly equivalent to the tax payable if the income had been earned directly by the shareholders. Since a 25-per-cent rate was applicable to the active business income of small Canadian-controlled private corporations, the system achieved integration for dividends from such corporations.

The first column of Table 7 illustrates this calculation by considering the example of a small private business corporation which earned $100. After paying $25 of corporate tax it distributed $75 of dividends to its shareholders. Under the 1972 rules they, in turn, grossed-up these dividends to $100 and paid tax at their applicable personal marginal tax rates. In computing their final personal tax liability they were allowed a dividend tax credit of $25. They thus included in their income an amount effectively equivalent to the pre-tax corporate income and received a credit for the tax already paid at the corporate level. The total corporate and personal tax was the same as would have been payable if the income had been earned directly by the shareholders.

While this system resulted in a high degree of integration of the corporate and personal tax for shareholders of small private companies, it suffered from a major drawback. It continued to levy more tax on dividends than on capital gains, only one-half of which were taxed. The system thus still provided opportunities for surplus stripping in the case of closely-held private companies. To continue the earlier example, the $75 of after-tax corporate income, if left in the corporation, would normally result in a $75 appreciation in value of the corporation's shares. If the individual shareholder could have realized this increment as a capital gain the combined corporate and personal tax on the $100 of corporate-source income would have been much lower than if the increment had been paid out as dividends. For an individual in a 50-per-cent tax bracket, the total corporate and personal tax on the $100 of business income received in dividends was $50. If this individual instead realized capital gains, the combined corporate and personal tax on the $100 of business income was $43.75 ($25 corporate tax plus a personal tax of $18.75 on the taxable capital gain of $37.50). For individuals in higher tax brackets the difference between tax on dividends and tax on capital gains was much larger.

With the introduction of half-taxation of capital gains in 1972, the rate of tax on designated surplus was reduced from 50 to 25 per cent. There were other substantial amendments to the designated surplus rules. Nevertheless, it turned out that the rules could still be circumvented, in some cases through the use of the tax-free rollover provisions that

Table 7

Taxation of Active Business Income Earned by a Canadian-Controlled Private Corporation and Distributed to its Shareholders

		1972 Rules	1978 Rules
		($)	
1	Pre-tax corporation income	100	100
2	Less corporate income tax	25	25
3	Equals corporate surplus available for distribution to shareholders	75	75
	A. Withdrawal of Corporate Surplus As Dividends		
4	Dividend received by shareholder	75	75
5	Plus gross-up of dividends (33 1/3 per cent and 50 per cent of dividends received under 1972 and 1978 rules respectively)	25	37.50
6	Equals amount added to shareholders' income for purpose of individual income tax	100	112.50
7	Shareholders individual income tax (at the assumed rate of 50 per cent)	50	56.25
8	Less dividend tax credit	25	37.50
9	Equals net individual income tax on dividends	25	18.75
10	Total corporate and individual income tax (lines 2 + 9)	50	43.75
	B. Withdrawal of Corporate Surplus as a Capital Gain		
11	Capital gain on the sale of corporation shares	75	75
12	Taxable capital gain	37.50	37.50
13	Shareholders' individual income tax	18.75	18.75
14	Total corporate and individual income tax (lines 2+13)	43.75	43.75

had been made available. In addition, the rules continued to interfere with legitimate business reorganizations. An analysis in 1974 found over 30 anomalies in the rules. These were addressed by adding new provisions and concepts to the law, but at the cost of greater complexity which created new problems without solving all the old ones.

Two other approaches were available to solve the problem at this stage. Either the tax on capital gains could have been raised or the tax on dividends reduced. In 1977 the government

chose the latter option and raised the dividend gross-up and tax credit from one-third to its current level of one-half of cash dividends received. This enrichment of the dividend tax credit lessened the differential between the taxation of dividends and capital gains, reduced the incentive for converting one to the other and permitted a considerable simplification of the rules designed to guard against tax abuse. As illustrated in Table 7 (second column), the differential at a 50-per-cent personal marginal tax rate was reduced from $6.25 to zero. For taxpayers with marginal rates below the 50-per-cent range (the exact threshold rate varies from province to province) it is now advantageous to receive corporate surplus in the form of dividends as opposed to capital gains. Capital gains are still more attractive than dividends for those with tax rates in higher ranges, but the differential is far less significant.

While this change achieved some simplification it was not without cost. First, the reduction in the tax on dividends reduced federal and provincial revenues by a significant amount. For 1979 the revenue cost is estimated to be some $200 million.

Second, while the change narrowed the difference between the effective individual income tax rates on dividends and on capital gains, it widened the gap between individual tax rates on dividends and on other forms of income. Table 8 shows the combined federal and provincial marginal individual tax rates on dividends, capital gains and other types of income at various taxable income levels. As can be seen the tax rates on dividends are now substantially lower than on other income. For most taxpayers (other than those in high tax brackets) the tax rates on dividends are less than one-half of those on other income. The tax on dividends is roughly equal to the tax on capital gains for those in upper-income brackets (from $39,792 to $99,788 of taxable income).

Third, the enrichment of the dividend tax credit detracted from integration of the corporate and shareholder tax systems for dividends from small Canadian-controlled private companies. The personal tax on business income earned through such companies is now lower than on the same type of income earned directly. This created incentives to incorporate purely for tax reasons and to receive employment income and other forms of

Table 8

Combined Federal/Provincial(1) Marginal Tax Rates on Dividends, Capital Gains, and Other Income at Various Income Levels, 1980

Taxable Income	Combined Federal/Provincial Marginal Tax Rate		
	Dividends	Capital Gains	Other Income
$		%	
Under 18,238	0	18	36
18,238 – 23,212	7	21	42
23,212 – 39,792	16	24	48
39,792 – 64,662	25	27	54
64,662 – 99,480	31	29	58
Over 99,480	40	32	64

(1) The provincial tax rate used in the example is 49 per cent of federal basic tax. This is an average provincial rate on federal basic tax.

income through a corporation. This resulted in attempts by high-income professionals (such as doctors, dentists, lawyers and accountants) and senior executives to provide their services through a corporation where this was possible. In order to prevent tax avoidance through such actions, amendments were made recently to the Income Tax Act to restrict the application of the low small business tax rate. Specifically the rate of tax on corporations providing certain professional, personal or other services was raised from 25 to 33 1/3 per cent. Thus, for this type of income, the corporate/shareholder tax system again became approximately integrated. The tax system continues, however, to be over-integrated for other forms of business income earned in other Canadian-controlled private corporations.

Whatever the advantages and disadvantages of the current system the fact is that the tax on dividends and capital gains is roughly in balance in the case of small Canadian-controlled private corporations eligible for the low (25 per cent) corporate tax rate. Any reduction in the rate of tax on capital gains would disturb the balance. To avoid tax abuse, widening of the difference between the effective rates of tax on capital gains and dividends would require a fundamental restructuring of the current system, with little likelihood of a satisfactory resolution of the surplus stripping problems faced earlier.

In spite of the considerable simplification achieved in 1978, the tax system continues to contain a general ministerial discretion provision that can be invoked to prevent blatant tax abuses. This provision has been criticized by tax practitioners and taxpayers as it makes the determination of tax liability subject to the discretion of the Minister of National Revenue on a case-by-case basis, which is contrary to sound tax principles. Its continued presence is indicative of the genuine difficulty in designing workable rules to determine the tax on surplus distributions where there is a differential treatment of dividends and capital gains. If the tax on capital gains were reduced or eliminated, increased reliance on such a provision to protect the tax system would be inevitable. While unsatisfactory, such reliance would be perhaps the only solution to the problem of minimizing tax avoidance.

It has been suggested that possibilities for surplus stripping exist only in the case of private, closely-held companies. It is thus claimed that the tax on other forms of capital gains could be reduced or eliminated without significant adverse consequences to the tax system. Such a view neglects the existence of a number of tax-free rollover provisions (described in Appendix I) in the current system. These provisions were introduced to facilitate corporate reorganizations designed to improve efficiency or to respond to changing market conditions. The rollover provisions would have to be restricted if certain types of capital gains were given preferential treatment. The difficulties created by rollover provisions in granting selective exemptions from capital gains taxation are discussed in greater detail in Section 8.

Effects on Investment and Growth

Adverse effects on savings, investment and economic growth are often put forward as the main justification for eliminating the tax on capital gains.

The concerns expressed fall into three main areas: effects of capital gains taxation on aggregate savings and investment; the extent to which it biases the flow of savings away from risky investments; and the relationship between taxation of capital gains and corporate financial liquidity. Each of these is examined below in turn.

Effects on Aggregate Savings and Investment

The issue here is whether, if there is a prospective capital shortage resulting from inadequate savings and investment, the inclusion of capital gains in income contributes to this inadequacy.

At one level this concern takes the form of questioning whether Canadian rates of private sector saving will be sufficient over the next decade to finance needed investment without upward pressure on interest rates or excessive resort to foreign borrowing. Alternatively, the concern may simply be that Canadian capital investment levels are inadequate and that an appropriate method of encouraging investment is to increase personal savings by reducing the tax on capital gains.

Whether current rates of savings and investment are adequate can be judged only against some relevant criteria. Three that can be used are estimated future capital requirements, past Canadian savings rates that allowed the country to experience reasonable rates of economic growth, and savings rates in other countries.

Although developing a list of future investment projects and summing them to arrive at future capital requirements is superficially plausible, it proves on inspection to be generally unreliable and to obscure important economic realities. Given limited resources, any increase in investment in one area means less resources are available for other wants such as consumption or other investment projects. If savings and investment are at levels consistent with achievable and sustainable growth rates, it is not clear why a list of investment projects calling for much higher levels of capital requirements should be given credence. If any investment is profitable enough to attract financing, it will go forward; if it does not meet this market test, there appears to be little reason not to delay or abandon it.

Of course, there may be projects of extreme national importance that cannot attract private sector financing because of their scope or the risks involved. Cases such as this call for project-specific government assistance rather than for broad-based tax measures such as reduction in taxation of capital gains.

A second benchmark for analysing the adequacy of Canadian savings is to compare current with past experience.

Table 9 presents information on the various sources of savings and total savings as a proportion of gross national product (GNP) in Canada since 1950. The following points are notable:

Total gross savings (and investment) as a share in GNP (line 6) have been remarkably stable over the period, averaging some 23 to 24 per cent. There is no evidence of a decline since the introduction of capital gains taxation, though any effects of taxation of capital gains on savings, at the aggregate level, may have been masked by other offsetting influences.

The net domestic private sector savings rate[3] (line 7) has risen significantly during the 1970s. This is due to a large increase in personal sector savings coupled with a roughly constant share of business savings in GNP. The increase in private sector savings has been offset by declines in government savings (due to a large extent to deficits at the federal level) leaving the net domestic Canadian savings rate (line 8) in the 1970s slightly lower than it was in the latter half of the 1960s.

Table 9

Components of Canadian Savings as a Percentage of Gross National Product, Selected Periods

		1950-54	1955-59	1960-64	1965-69	1970-74	1975-79
				(%)			
1	Personal Sector	5.4	3.1	3.0	3.7	5.1	6.9
2	Business Sector	3.8	4.2	3.8	4.0	3.4	4.0
3	Government	3.0	1.8	1.6	3.8	3.2	−0.6
4	Non-Residents	1.3	3.6	1.7	1.3	0.3	2.4
5	Capital Consumption Allowances	10.2	12.0	12.2	11.6	11.0	10.9
6	Total Gross Savings	23.5	24.9	22.4	24.4	23.3	23.7
7	Net Domestic Private Sector Savings (lines 1 + 2)	9.2	7.3	6.8	7.7	8.5	10.9
8	Net Domestic Savings (lines 1 + 2 + 3)	12.2	9.1	8.4	11.5	11.7	10.3

Notes:
Business savings are undistributed corporate profits. They include savings of government business enterprises and are net of the inventory valuation adjustment. Personal sector savings include savings of unincorporated businesses and the adjustment to reflect accrued but unrealized farm income arising out of the operation of the Canadian Wheat Board. Government savings are any excess of revenues over expenditures for all levels of government combined. Savings by non-residents take the form of net capital inflows, both direct and portfolio, into Canada.
Total gross savings equals total gross capital formation except for differences due to the residual error of estimate in the National Income and Expenditure Accounts. Net domestic savings equals net investment.
Details may not add to totals due to the residual error of estimate in the National Income and Expenditure Accounts.
Source: Statistics Canada, *National Income and Expenditure Accounts*.

(3) Net savings is gross savings less that amount needed to maintain the capital stock in the face of depreciation due to wear and tear and obsolescence. Net savings equals net investment.

Non-residents have provided a larger portion of savings in the 1970s (line 4) than in the past, with the exception of the 1955-1959 period. Annual data reveal, however, that the role of non-residents has been declining since 1975.

Inflation does have a distorting effect on the measurement of savings. Savings have, however, gone up in real terms and real increases in the personal sector savings rate during the 1970s accounted for more than half the nominal increase shown in Table 9.(4)

It is clear from this information that private sector savings cannot be judged inadequate when compared with past levels. Private sector savings are, in fact, now higher than their historical levels and have been a cause of concern in terms of their short-term impact on aggregate demand and employment. The government has had to initiate fiscal measures to stimulate consumption and investment expenditures. Such measures have resulted in deficits in the government accounts.

The adequacy of Canada's savings rate can also be assessed by comparing it with rates in other countries. Table 10 shows rates of gross private-sector savings as a percentage of gross domestic product (GDP) for OECD countries. Canada's savings rate is midway in the range reported for these countries. It ranks above those in the United States, France and the United Kingdom.

Whether or not there are insufficient Canadian savings, would a reduction in taxation of capital gains materially affect total savings and investment? This cannot be answered in the abstract, as it depends on how much saving actually responds to rates of return available to savers.(5)

Based on available evidence, reductions in tax on capital gains appear unlikely to produce a large increase in Canadian savings. First, empirical evidence suggests that savings are not very responsive to changes in the after-tax rate of return. Recent estimates suggest the elasticity of savings with respect to changes in rates of return to be, at most, 0.3.(6) That implies that a 10-per-cent increase in the after-tax rate of return to savers, i.e., from 10 to 11 per cent would increase savings by 3 per cent, i.e., from 20 to 20.6 per cent of income.

Second, while the tax revenue from inclusion of capital gains in income for tax purposes is important, it is a relatively small fraction of the total tax on investment income. Other elements such as the corporate income tax and personal taxation of dividend and interest income are far more substantial. Thus, changes in the tax treatment of capital gains would not produce large changes in the average return from savings.

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(4) See *The Recent Behaviour of the Personal Savings Rate*, Department of Finance, April 1980, p.45.

(5) Any increase in rates of return (brought about, for example, by a reduction in tax on capital gains) will not necessarily increase savings. The increased return from savings makes using income for current consumption less attractive as opposed to saving for consumption in the future, thus tending to induce more savings. On the other hand, the increased return means that any given level of savings results in larger possible consumption in the future. An increase in the after-tax return to saving from, for example, 5 to 10 per cent permits an individual, who had a target accumulation of $5,000 a year from now, to reduce his current savings from $4,762 to $4,545. The theoretical effect of increases in after-tax return on savings is thus ambiguous and is a matter for empirical analysis. As noted in the text, empirical studies have found the relation between savings and rates of return to be weak.

(6) These estimates are disputed for various methodological reasons and they should be regarded as the maximum possible response. For many years it was, in fact, estimated that a 10-per-cent increase in after-tax rates of return would cause, *at most*, a one-per-cent increase in savings i.e., an elasticity of 0.1.

Table 10

Gross Private Sector Domestic Savings as a Percentage of Gross Domestic Product, Selected OECD Countries Ranked by Size of Savings Rate, 1972-1976

	Average Gross Private Savings Rate[1] 1972-1976	Gross Private Savings Rate 1976
	(%)	
Japan	29.8	29.3
Austria	26.9	27.2[3]
Italy	22.5	24.1
Switzerland	26.1	23.3
Belgium	24.3	23.3
Netherlands	22.5	22.7
Australia	21.4	21.2
Greece	23.7	21.1
Germany	21.5	20.9
Canada[2]	20.0	20.6
France	21.0	19.7
Spain	21.0	18.0
United Kingdom	15.9	18.0
Norway	18.4	17.9
United States	17.6	17.2
Finland	20.7	16.8
Sweden	18.0	15.4
Denmark	12.5	12.7
Portugal	20.2	12.6[3]

(1) Gross private savings equals net personal and business savings plus social security funds and non-governmental capital consumption allowances.
(2) The gross private savings rates presented in this table differ slightly from those calculated from Table 8 because of the use of gross domestic product rather than gross national product in the denominator and certain methodological differences in the OECD data.
(3) 1975 data.
Source: OECD, *National Accounts of OECD Countries*, 1976, Volume II.

Full exemption of capital gains from tax would raise the after-tax return on total private savings by about 2 1/2 per cent, i.e., from, say, 10 to 10.25 per cent.[7] Under optimistic assumptions about the responsiveness of savings, the increased return to savers resulting from full elimination of the tax on capital gains would raise private savings by $325 million per year. Relatively this amount is not large. It represents about one-half of one per cent of annual private investment in non-residential construction and machinery and

(7) This estimate for 1976 is obtained by expressing the revenues from taxation of capital gains as a percentage of after-tax (personal plus corporate) investment income accruing to Canadian residents. Investment income includes the portion of corporate profits accruing to Canadian residents and private sector international miscellaneous investment income. Taxes subtracted from income include corporate profits tax as well as individual income tax on interest, dividends (net of dividend tax credit), capital gains and other investment income. Data on corporate taxes are taken from the national accounts. Individual taxes were estimated from Revenue Canada statistics on individual tax returns. Data on pre-tax income flows are generally from the National Accounts.

equipment. It is less than 5 per cent of current rates of net capital inflows from abroad. Thus, even full elimination of the tax on capital gains could not be expected to have any noticeable impact on total investment or the requirements for foreign capital inflows.

Moreover, any added savings resulting from tax reductions on capital gains would not necessarily be channelled into increased investment in business plant and equipment. The immediate benefit of any tax reduction would accrue primarily to holders of real estate investments and corporate shares. Capital gains on business plant and equipment are relatively insignificant. Added demand for corporate stock could indirectly facilitate business investment, by making it easier for corporations to raise new equity. *However, a large portion of the stimulus to equity markets would be in respect of already outstanding shares, and would merely provide windfall gains to existing shareholders.* Also, if the measure were to result in a larger government deficit that was financed by borrowing, total savings available to the business sector could in fact fall. Alternatively, if the increased deficit were financed by a general increase in other taxes, some portion would fall on investment income and business profits, thus directly affecting the return on investment.

These facts reinforce the viewpoint that reductions in capital gains taxation are not a particularly effective method of increasing the share of Canada's output going to investment in business plant and equipment. Far more direct methods exist of directing fiscal resources to the promotion of capital accumulation over the medium and longer term.

Effects on Risk-taking

The issue here is to what extent the present tax treatment of capital gains contributes to an insufficient level of risk-taking in Canada. Are smaller, riskier businesses, start-ups, high-technology businesses and the like being hampered by the taxation of capital gains? Often in public discussions this concern is also expressed in a feeling that the tax system is discouraging "entrepreneurship" or "risk-taking". This particular concern is not over Canada's total flow of savings and investment but rather over the allocation of the flow among competing uses.

Some people feel that the taxation of capital gains discourages what they regard to be desirable entrepreneurial activities which are important for Canada's future growth. In addition, they note that tax provisions such as deductions for pension plan contributions, registered retirement savings plans, other deferred income plans, the favorable tax treatment of personal residences, the exemption of the investment income portion of life insurance proceeds, and various other tax shelters bias Canadian savers towards placing their funds into these forms of saving as opposed to other ventures.

This attitude is based on the assumption that capital gains are most likely to accrue in risky ventures and, therefore, the taxation of capital gains will tend to reduce risk-taking. However, as noted earlier, capital gains, as defined for tax purposes, accrue on a wide range of assets not all of which entail high risk. In addition, risky ventures frequently yield a return in the form of business income and not capital gains. Thus, tax relief for capital gains may not be an effective means of encouraging risk-taking. It is also not obvious that the taxation of capital gains necessarily reduces the propensity to take risks. While capital gains are taxable, the government does share in capital losses within limits through their deductibility from other sources of income (in the case of shares and debt of Canadian-controlled private corporations, losses are immediately deductible from other income without limit). This sharing by government in losses through the tax system offsets to some degree the potential impact of any bias against risk-taking.

It is true that the current tax system does promote a larger flow of savings into personal residences and pension plans. This does not result from the taxation of capital gains per se. In the case of personal residences it is due in part to the exemption from tax on any capital gains and from the fact that imputed income on the equity in a home is not taxed in Canada. Savings in pension plans are encouraged directly through deductibility of contributions and deferral of tax on investment income. These preferences were provided as a matter of deliberate government policy. If they result in an undesirable bias in the allocation of savings, the logical course of action would be to modify or withdraw the preferences rather than to extend preferences to other investments.

The alleged implications for risk-taking from the taxation of capital gains are extremely difficult to quantify and analyze. There is no way to quantify the riskiness of a particular business. There is no necessary close correlation between size and risk, or innovation and entrepreneurship, though small ventures are very often more risky than larger ones. Even the idea of a "start-up" is not well defined, since a new corporation can be formed on the amalgamation or winding up of old corporations and since an existing corporation can start up a new line of business or new venture without incorporating a new entity. Certainly, it is possible to produce particular examples of businesses that have not been able to obtain the capital they want, when they want it, or at a price that is acceptable. However, a function of capital markets is to allocate capital and not all investments will be attractive to investors. One of the major difficulties in this area is to distinguish between the natural and legitimate rationing of credit, the ordinary function of the market system, and cases where market imperfections or the structure of the tax system have an undesirable impact.

Another implication of the imprecise nature of phenomena such as riskiness, innovation, and entrepreneurship is that it is extremely difficult to design tax measures that promote businesses with these characteristics. A broad-based reduction of tax on capital gains would apply to gains earned in a variety of companies which do not possess the attributes that the measure is trying to support. It would thus be inefficient and potentially costly. However, attempting to single out gains on shares in certain businesses for special treatment, in order to improve the target-effectiveness of the measure, would involve detailed rules and bureaucratic discretion, and would lead to increased complexity and uncertainty in the application of tax law, both of which could easily vitiate the effectiveness of the measure.

The federal tax system contains a number of specific measures designed to enhance the attractiveness of various kinds of investments. Examples include the lower tax rate on small business, accelerated depreciation, and tax credits for research and development and for certain specified categories of investment. Approaches such as these may be more fruitful than singling out particular capital gains for preferential tax treatment.

Effects on Corporate Financial Liquidity

It is sometimes argued that taxation of capital gains coupled with preferential tax treatment of certain less risky returns to saving has biased Canadians against investing in corporate equity, and that this trend is reflected in poor stock market performance, declining individual participation in stock markets, institutionalized saving, and difficulty for corporations in raising new equity as reflected in rising debt-equity ratios.

While recognizing the difficulties encountered by the business sector in raising equity capital, the effects of taxation of capital gains on equity markets should not be overstated. Capital gains and dividends are taxed at lower effective rates than interest payments. This

is the result of half-taxation of capital gains, the dividend tax credit, and the tax deferral on accrued but unrealized gains.

In addition, other influences that have affected equity markets may well have been much more important than the taxation of capital gains. *Indeed, as Chart 3 shows, Canadian markets have outperformed those in the U.S. since tax reform, and especially in 1978 and 1979, despite the fact that Canada began taxing capital gains in 1972, while capital gains have been subject to taxation in the United States since 1913.* It is apparent that factors such as uncertainty, inflation, relatively high pre-tax return on interest-bearing assets, and lowered expectations of economic and profit performance due to worldwide economic trends have been far more influential than taxation of capital gains in influencing stock market performance. This suggests that changes in capital gains taxation might well have only a small and transitory effect on market performance and on the ability of corporations to obtain new equity financing. Also, as noted earlier, under such a measure a significant share of benefits would accrue as windfall gains to existing holders of outstanding equity.

There has also been concern that individual investors have not been participating in stock markets with the result that markets are becoming more institutionalized, their breadth and liquidity are being reduced, and institutions are not providing funds to smaller, newer enterprises. It is true that the percentage of the adult population receiving dividend income fell between the late 1960s and 1970s, as shown in Table 11.

However, data for 1977 and 1978 suggest that the decline may have been halted and reversed, and the improved market performance in 1978 and 1979, along with the enrichment of the dividend tax credit in 1978, could well lead to further increases in individual participation. Moreover, lowered individual participation may well have been due not so much to taxation of capital gains as to poor performance of equity markets in the first half of the 1970s, the relatively high nominal yield on debt instruments, and

COMPARISON OF COMMON STOCK PRICE PERFORMANCE
CANADA AND THE UNITED STATES
1971 - 1980

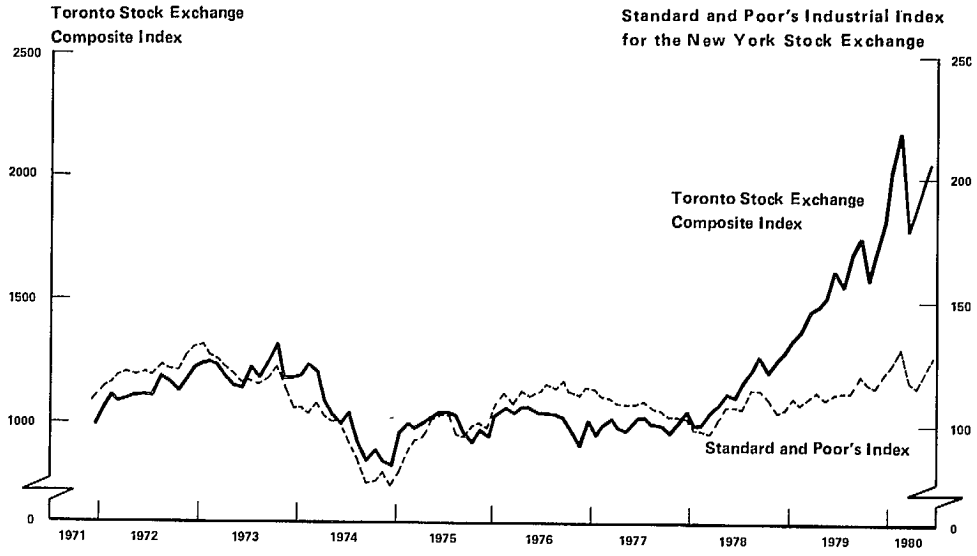

Table 11

Individual Stock Ownership Trends as Indicated by Tax Filers Reporting Dividend Income, 1968-1978

	Tax Filers with Dividends	
	Number	As a Percentage of Adult Population(1)
	('000)	(%)
1968	871	6.3
1970	998	6.9
1972	888	5.8
1973	907	5.8
1974	892	5.6
1975	884	5.4
1976	836	5.0
1977	857	5.0
1978	971	5.6

(1) Adult Population is population age 15 or over.
Source: Revenu Canada, *Taxation Statistics.*

individual investor perceptions of the relative risks and returns involved in alternative investments under existing world economic conditions.

One of the reasons leading commentators to recommend changes in taxation of capital gains is the apparent "lack of strength" in corporate balance sheets. It is widely noted that the ratio of debt to equity has risen in recent years. This is believed to increase the financial risks of corporations, including that of bankruptcy.

The ratio of debt to equity for industrial corporations during the 1970s is shown in Table 12. It is clear that the ratio of total debt to shareholders' equity has increased over the period. The magnitude of the increase, however, depends upon the way the debt-equity ratios are calculated. The debt-equity ratio referred to by commentators often includes deferred taxes in total debt. Deferred taxes arise because the tax system permits a write-off of depreciable assets and other costs that is faster than companies use for financial reporting purposes. Potentially, the difference in taxes on the two bases may be payable in the future and is thus shown as a deferred tax liability in companies' financial statements. However, as long as companies do not actually decline in size, the deferred tax liability is not likely ever to become payable. As a result, the deferred taxes have the characteristics of a permanent source of financing without an attached interest cost, so that it is more appropriate to include these with equity than with debt. Indeed, one of the major purposes of the introduction of fast write-offs in the 1970s, i.e., the two-year write-off for manufacturing and processing equipment, was to improve corporate cash flow and the ability of business to finance new investment. *Including deferred taxes with equity (second column of Table 12) leads to the conclusion that increases in the debt-equity ratio up to 1975 were not as significant as is often suggested. Since 1975, conventional as well as adjusted debt-equity ratios have been declining.*

Table 12

Debt-Equity Ratios, Private Non-Financial Corporate Sector, All Industries, Canada, 1970-1978

	Total Debt to Shareholders' Equity[1]	Adjusted for Deferred Tax Liabilities[2]
1970	1.07	0.92
1971	1.06	0.91
1972	1.07	0.91
1973	1.08	0.92
1974	1.14	0.95
1975	1.19	0.97
1976	1.19	0.96
1977	1.18	0.95
Revised Series[3]		
1975	1.43	1.18
1976	1.42	1.16
1977	1.38	1.13
1978	1.38	1.12

(1) The definition of debt adopted here covers all liabilities.
(2) Adjusted debt-equity ratios are total debt less deferred tax liabilities to shareholders' equity plus deferred taxes.
(3) Starting with the third quarter of 1978, a new sample of industrial corporations was introduced by Statistics Canada and financial information on the new basis made available back to 1975. There are major differences in the coverage of the revised series and the resulting debt-equity ratios are not comparable with the previous series.
Source: Department of Finance, *Rate of Return and Investment Profitability*, April 1980.

It must also be remembered that increases in the debt-equity ratio are advantageous to corporations in an inflationary period. The advantage arises from the fact that all of the nominal interest costs are deductible from income subject to corporate tax, even though part of these interest costs in an inflationary period merely represents a return of capital to the lender sufficient to ensure that the real value of his bond holding is not eroded. As a result, corporations prefer to finance relatively more by debt and thus obtain a deduction for more than their real costs of borrowing.

Another reason why corporations prefer financing by debt is that the general deductibility of interest costs results in income being taxed only once, that is, in the hands of the lending corporation or individual. In contrast, financing by equity leads to both corporate tax on the income and personal tax on any dividend distribution. While the dividend tax credit reduces the shareholder tax by more than the amount of tax paid at the corporate level in the case of small businesses, the offset is not complete for many large corporations. The basic asymmetrical tax treatment of dividends and interest at the level of the corporate tax can lead to more of a bias in favour of debt finance than does the taxation of capital gains.

Any change in the tax treatment of capital gains would have its largest impact on the use of corporate profits rather than on the extent of financing by debt or equity. *A preferential treatment of capital gains vis-à-vis dividends results in a bias towards corporations retaining income rather than paying it out to shareholders in the form of dividends.* This leads to

larger accrued share gains. The bias arises for two reasons. First, for high-income shareholders, tax on realized capital gains is less than on dividends. Second, for all taxpayers, the personal tax on capital gains that arise from retained earnings can be deferred merely by holding the security and not realizing any immediate gain. A reduction in tax on capital gains would exacerbate this bias. *From the point of view of the efficient use of the economy's savings over the longer run, it is not clear that encouraging financing of projects out of retained earnings without recourse to the test of capital markets is a suitable policy.*

Issues in Taxation of Capital Gains

The previous sections have described the role and importance of capital gains under the Canadian tax system. This section discusses certain issues that have been raised in public discussions about the method of taxation of capital gains. They do not relate directly to the basic question of whether capital gains should be included in income for tax purposes. Rather, they relate to the measurement of capital gains and the operation of other specific tax provisions. The issues considered here are the determination of capital gains in an inflationary period, the treatment of capital losses, the lock-in effect, and the problems arising from the lumpiness of capital gains.

Inflation and the Measurement of Capital Gains

Perhaps the major criticism levied against the current provisions relating to the taxation of capital gains is that they fail to distinguish between real capital gains and those which are purely nominal. *It is argued that increases in the value of assets which merely keep pace with inflation in no way enhance the economic power of the asset holder and ought not, therefore, be subject to taxation. Indeed, the imposition of tax in these circumstances can be tantamount to a levy upon capital and so quite inappropriate under the guise of income taxation.*

While this effect is generally recognized, it must be noted that there are several provisions which, for many taxpayers, substantially mitigate the tendency of the present tax system to tax purely inflationary gains. In the first place, only one-half of realized gains need be taken into income for purposes of taxation. Second, since only realized gains are subject to tax, taxpayers usually have the option of deferring the actual payment of the tax. Actual tax liabilities may, therefore, be minimized by timing realizations in such a way as to match them with realized losses. As well, since tax on accrued gains can be deferred, its impact in present value terms is lessened. Third, any interest costs incurred to finance the capital property are fully deductible for purposes of taxation each year as incurred, while only half of the associated gain is included and then only when realized. Given the discount rates which have prevailed in recent years, these tax rules reduce significantly the effective rate of tax on taxable gains. Moreover, in an inflationary environment, only a portion of interest payments on debt is a real cost to the borrower, the remainder merely represents a compensation to the lender for the decline in the real value of debt. To measure real income accurately, only real borrowing costs should be deductible. Last, the exclusion from taxable income of the first $1,000 of investment income, including capital gains, provides a further offset to the effects of inflation on the measurement of capital gains.

Data are not available to determine the extent to which taxation of illusory gains in recent years has been offset by the factors noted above. However, Table 13 provides illustrative examples of the extent of this offset. As the value of the offset depends on the length of time assets are held and on the proportion of the purchase price financed by borrowing, the table covers a range of cases. It shows, for various combinations of holding period and ratio of debt to purchase price, the threshold rate of inflation below

which the current tax system results in less tax than would a system of taxing *inflation-adjusted capital gains, in full, as accrued*. For example, for an asset that is 50-per-cent debt financed and that is held for four years before being disposed of, the current tax provisions more than compensate for the lack of inflation adjustment as long as the inflation rate is less than 13.2 per cent per annum. If this asset is held for five years or longer the current treatment compensates for lack of adjustment at any rate of inflation. *It is clear that for capital properties financed predominantly by borrowing, the current tax system provides full offset at all foreseeable rates of inflation. In fact, the current system over-compensates in a significant range of cases.*

Table 13

Annual Inflation Rates below which Current Tax Treatment of Capital Gains is more Favourable to Investors than Full Taxation of Inflation-Adjusted Capital Gains on an Accrual Basis

Holding Period	Percentage of Purchase Price Financed by Borrowing				
	0	30	50	75	90
(years)	(annual % inflation rates)				
1	3.6	5.3	7.8	21.5	*
2	3.8	5.7	8.8	*	*
3	4.0	6.2	10.3	*	*
4	4.2	6.8	13.2	*	*
5	4.5	7.5	20.0	*	*
7	5.1	9.8	*	*	*
10	6.3	*	*	*	*
15	11.1	*	*	*	*
20	*	*	*	*	*

* Indicates that current tax treatment is more beneficial at all inflation rates.

Notes:

1. The table does not take into account the fact that the first $1,000 of investment income, including capital gains, is not taxable.
2. It is assumed that the capital property appreciates in real terms at 3.5 per cent per year and that the real cost of borrowing is 2.0 per cent. An after-tax discount rate of 1.2 per cent is assumed. The offset depends on the size of real gains. The current tax treatment is more beneficial than shown in Table 13 if the capital property appreciates in real terms at a higher rate than 3.5 per cent per year and less beneficial if the real rate of appreciation is less than 3.5 per cent.
3. The debt is assumed to be amortized over the holding period of the asset.

While these various factors do not provide an appropriate offset in all cases to the taxation of purely nominal gains under the present system, it is, nevertheless, probable that the revenue yielded by this system is of the same order of magnitude as that which would result from the full taxation of inflation-adjusted capital gains on an accrual basis. The distribution of liabilities would, however, differ significantly under the two systems. It is important to inquire, therefore, if there is available any practicable comprehensive or partial adjustment mechanism which would significantly improve the taxation of capital gains in an inflationary environment.

Indexing of Costs of Capital Properties

Indexing is, perhaps, the proposal most frequently put forward to deal with the mismeasurement of capital gains during inflationary periods. In concept, this proposal is very simple. It involves increasing the cost base of a capital property annually by a factor based upon a price index. For example, the cost of an asset purchased for $10,000 could be indexed to $10,600 after a year of inflation at 6 per cent. Thus, only appreciation of the asset in excess of 6 per cent would be taxable if the asset were sold at the end of the year.

A number of policy concerns arise in designing a suitable indexing mechanism for capital gains. These include the consequences of providing inflation adjustment for capital gains alone and not for other forms of investment or business income, the need for an appropriate adjustment for debt-financed assets, and the technical complexity of the provisions. These are discussed in turn below.

Scope of Indexing

Inflation distorts the measurement of not only capital gains but also other forms of investment and business income. For example, in an inflationary period, if a taxpayer puts $1,000 in a savings deposit yielding 10-per-cent interest income, and inflation in the year is 6 per cent, some $60 of nominal interest income does not represent a real increase in his ability to pay taxes. However, the full $100 of nominal interest income is taxed. The mismeasurement of business income under current accounting conventions based on historical costs is widely recognized. It occurs since financial statements which fail to take account of inflation understate the cost of inventories and depreciable assets and thereby overstate profits. The overstatement of profits is offset to the extent that a company is not required to report the benefit to the business due to a decline in the real value of its debt liabilities.

The distorting impact of inflation on the measurement of income has long been recognized and has been the subject of extensive investigation. Unfortunately, while our understanding of these effects has been considerably enhanced, the accounting profession in Canada has not yet formulated a comprehensive system for measuring the impact of inflation upon income. Given the dependence of the tax system on generally accepted accounting principles, it is not yet possible to deal with the capital gains/ inflation interaction within the context of a comprehensive adjustment mechanism that would embrace both capital gains and other forms of income. Indeed, it is necessary to caution that even if such a comprehensive adjustment mechanism available, the potential transfer of tax revenue to foreign treasuries which could result from its earlier adoption here might delay its use in Canada for tax purposes, until comparable mechanisms were operative in other jurisdictions.

While there is no comprehensive inflation-adjustment mechanism available at this time, it has been suggested that the Canadian tax structure would be improved if a partial adjustment mechanism were applied to capital gains alone. The concept is straightforward. The adjustment would take the form of an annual adjustment to the cost base of capital property, using an appropriate price index. Only dispositions at prices in excess of the indexed cost base would then generate taxable gains.

This partial approach gives rise to several policy concerns. In the first place, it is discriminatory. While it is acknowledged that inflation distorts the measurement, and hence the taxation, of virtually all forms of investment and business income, only capital gains would benefit from the adjustment. This would add further to the advantages now accorded to capital gains vis-à-vis other forms of income with attendant economic and capital market implications.

Second, unless restrictions were imposed upon the scope of capital gains indexing, it would not be possible effectively to segregate the inflation adjustment of capital gains from that of business income and interest income. A consideration of the repercussions of such an adjustment on depreciable property and debt instruments should make this clear.

It is now widely recognized that accounting for depreciable assets on the basis of historic cost is one of the major sources of distortion in the measurement of income in an inflationary setting. With replacement costs possibly much higher than historic acquisition costs, it is recognized that, ignoring incentive provisions, the capital cost allowances (CCA) permitted under the tax system tend to overstate taxable income. Some form of indexation or adjustment of depreciable property is thus a part of virtually every comprehensive scheme for restating income to take cognizance of the effect of inflation. What is less widely recognized is that an inflation adjustment for capital gains alone would be tantamount to creating a capital cost allowance loophole for those taxpayers who were in a position to dispose of depreciable assets which had risen in value as a consequence of inflation. An example may serve to make this clear.

Consider the case of someone whose depreciable assets, purchased at a price of $100 per unit, now have a market value of $200. If the CCA rate allowed on these assets is 20 per cent, the original purchaser could claim a deduction of $20 in the first year in determining taxable income. In contrast, anyone who could establish a cost base at a market value level of $200 would be able to avail himself of the higher CCA ($40) associated with the inflated value of these assets. A restricted adjustment mechanism applying only to capital gains would provide incentives to taxpayers to indulge in artificial buy-and-sell or swap transactions to establish higher values for capital cost allowance purposes.(8) Most of such transactions are not now advantageous because the difference between the sale price of an asset and its undepreciated capital cost is taxable either as a recapture of depreciation previously claimed or as a capital gain. With the indexation of capital gains, the write-up of the cost base of the assets would eliminate any tax upon purely nominal gain and the transaction would thus become advantageous. This would be tantamount to a back-door way of indexing capital cost allowances for some taxpayers. Such back-door indexing would be inefficient and undesirable as it would not be available to all businesses and would again be a partial adjustment of business income. Moreover, where a depreciable asset was sold at a price below its indexed cost base, the deductibility of any resulting capital loss from income, if permitted, would be equivalent to a retroactive inflation adjustment of depreciation allowances previously claimed.

As a second example consider the indexing of debt instruments that give rise to interest income. Such instruments are capital properties and would be eligible for inflation adjustment. Ignoring again the effects of half-taxation of capital gains, such an adjustment would be tantamount to inflation adjustment of interest income. *For example, the adjustment of the cost base of Canada Savings Bonds would give rise to a capital loss on their redemption which taxpayers could use to reduce their income. Deductibility of this inflation-created loss from income would be identical to taxing only that portion of interest received that represented a return in excess of the rate of inflation.*

While inflation adjustment of interest income may or may not be desirable, achieving it by indexing capital gains would raise the revenue costs of capital gains indexing and would be discriminatory in that only some types of interest-earning assets would be eligible for an adjustment. For example, such an adjustment could not apply to savings deposits. Moreover, such an ad hoc adjustment to interest income of lenders could

(8) Appendix II provides an example of this process.

give rise to capital market distortions and large revenue cost if borrowers continued to be allowed full deduction for their interest expense.

If, for such reasons, back-door extensions of indexing to other investment income or business income were not desirable, it would be necessary to exclude depreciable assets and interest-earning assets from the scope of indexing. Another alternative would be to deny the deductibility of inflation-created capital losses on such assets from other income. Any such restrictions would, in turn, give rise to other complexities. For example, assets can be held by individuals directly or through a corporation. When they are held in a corporation its shares would be eligible for indexing adjustment and thus gains on the underlying assets would be indexed implicitly. It would be discriminatory and inequitable to deny indexing on assets held directly but to index gains on the same assets if they are held indirectly through a corporation.

If it were decided to index at least all investment income it would be necessary to determine how comprehensive such an adjustment should be. Should it extend to bank accounts and term savings deposits? Since investment income other than capital gains is fully taxable, should the inflation adjustment be fully deductible or only half deductible as in the case of capital gains? Or should capital gains become fully taxable under an inflation-adjusted system? Should any inflation adjustment of interest income be restricted only to individuals or also apply to corporations?

Decisions on the scope of inflation adjustment would have a significant impact on its equity, economic effects and on its practicability. They would also be a major determinant of its revenue cost.

Adjustment for Debt

Undoubtedly, serious problems would arise in attempting to index capital gains for assets which are financed by debt. The asymmetry of the present tax treatment of capital gains and associated financing costs has already been noted: gains are subject only to a 50-per-cent inclusion when realized, while any associated financing costs are fully deductible when incurred. To index the former while ignoring the benefit conferred upon the borrower by the erosion of the real value of his indebtedness through inflation would be to overcompensate for the effects of inflation.

Consider the example of an investor who borrows $8,000 to acquire a capital property costing $10,000, the remaining $2,000 being available from his own resources. Assume further that he must pay interest on the borrowed funds at the rate of 5 per cent, that no inflation is expected or occurs in the course of the year, and that, as a consequence of an increase in the demand for the property in question, he is able to dispose of it at the end of the year at a price of $10,500. The following summarizes these events and their taxation under the present tax system:

1	Purchase price of property	$10,000
2	Selling price of property	10,500
3	Nominal capital gain	500
4	Real capital gain	500
5	Amount borrowed	8,000
6	Nominal interest cost	400
7	Real interest cost	400
8	Real income (line 4 – line 7)	100
9	Loss for tax purposes (one-half line 3 – line 6)	(150)

It is evident from the example that this taxpayer has experienced a real capital gain of $500, has incurred a real borrowing cost of $400, and has had a net increase in real income or net worth of $100. Under the present tax regime, he would be required to take into income one-half of his nominal gain of $500, or $250, and would be permitted to deduct his entire nominal interest cost of $400. He would thus have a loss of $150 for tax purposes, which could be used as an offset to other income. This favourable tax result is, of course, attributable to the requirement that only half of the nominal gain be included in income for purposes of taxation.

If on the conditions of this example a fully anticipated inflation of 5 per cent is superimposed then the taxpayer is actually made better off. The situation of the taxpayer is improved still further if he is permitted to index the cost base of eligible capital property. The results may be summarized as follows:

1	Purchase price of property	$10,000
2	Selling price of property	11,000
3	Nominal capital gain	1,000
4	Real capital gain	500
5	Amount borrowed	8,000
6	Nominal interest cost	800
7	Real interest cost	400
8	Real income before tax (line 4 – line 7)	100
9	Loss for tax purposes without indexation of gain (one-half line 3 – line 6)	(300)
10	Loss for tax purposes with cost base indexed (one-half line 4 – line 6)	(550)

Again, the taxpayer's real income is $100, but if he were permitted still to claim the full nominal borrowing cost and required to include only one-half of the real gain as a result of indexing, he would be able to claim a loss for tax purposes of $550 as an offset to other income. This disparity between the actual increase in real income and the loss which would otherwise be claimable makes clear the necessity of reducing the nominal interest cost by the amount of the decrease in the real value of the sum borrowed, i.e., reduce nominal interest costs by $400, equal to 5 per cent of $8,000. This would again result in a loss of $150 for tax purposes, as in the first example. Of course, it may be argued that, with the indexing of the cost base of the property generating the capital gain, there is no longer any rationale for including only one-half of the real capital gain in income for purposes of taxation. It is clearly the case, however, that the taxpayer should be permitted to deduct only the real cost of borrowed funds or, alternatively, that he be required to take into income an amount equal to the decrease in the real value of the sum borrowed.

Before commenting on possible ways of taking debt into consideration in indexing capital gains, it should be noted that if borrowers were required to add to their incomes the decline in the real value of their indebtedness, lenders ought, logically, to be permitted to exclude from income that portion of interest receipts that merely represents the decline, or compensation for the decline, in the real value of the amount lent. If this were not done, but borrowers were required to take into income the decline in the real value of the amount borrowed, a significant capital market distortion would result.

The ease with which a debt adjustment could be introduced into the tax system depends crucially on the scope of permitted indexing. For example, if it were intended that all investment and business income benefit from the adjustment process, than all income-

producing assets and associated liabilities would be subject to indexation. This would result in debtors being required to take into taxable income each year an amount equal to their total outstanding debt subject to indexation times the inflation rate for the year; lenders would be permitted a similar deduction for the decline in the real value of their loan assets. Debtors would not be required to make any adjustment in respect of personal loans. Since a distinction between personal loans and other forms of indebtedness is already incorporated into the tax system, for purposes of determining the deductibility of interest costs, this would occasion no additional complexity.

If indexing is to apply only to capital gains, however, then it would be necessary to separate from a taxpayer's total debt the portion that is, or is deemed to be, associated with properties giving rise to capital gains. However, since it is generally impossible to associate particular assets with a particular debt, any allocation of debt to particular assets of the taxpayer would be arbitrary. The debt adjustment would thus have to be computed in aggregate taking into account all the capital and business assets and non-personal liabilities of the taxpayer. The overall ratio of debt to assets for a taxpayer would be used to determine what proportion of his capital properties were considered to be debt-financed. The indexing adjustment would only apply to the remaining fraction. For example, if non-personal debt represented 50 per cent of relevant assets and the inflation rate was 10 per cent, the inflation adjustment would be to add 5 per cent to the cost base of capital properties eligible for indexing. A number of consequences flow from the need to determine the debt adjustment on a balance-sheet basis:

Because the amount of debt can vary during the time any capital property is held, it would not be sufficient to make the debt adjustment only in the year the property is sold. An appropriate debt adjustment would require annual computation of the amount of inflation adjustment for all properties held in the year with the associated debt adjustment based on the portfolio of assets and liabilities held in the year. The taxpayer and Revenue Canada would be required to maintain a record of the cumulative inflation adjustments to the cost base of each property until each is sold. Even though the adjustment would be computed for each year separately, it would not be reflected in the tax return of the taxpayer until the eventual disposition of a given property when the realized gains would be subject to tax.

In the case of corporations, the requirement to file a full annual balance sheet could be a relatively simple task as they are already required to prepare such a statement for financial accounting purposes. It would, however, be a new requirement for individual taxpayers, and accounting for changes in balance sheets during the course of a year would be difficult.

It would be necessary to decide which assets and liabilities are to be included in individuals' balance sheets. Presumably the debts would not include personal loans, carrying charges on which are not deductible for tax purposes. Consideration would have to be given to the inclusion of personal-use property, pensions, RRSPs and resource properties. Presumably personal residences would not be included in assets nor would mortgages thereon be included in debts. Recognition might have to be taken of the fact that mortgages can be incurred to finance purchases of financial assets.

The various items in the balance sheet would be assigned the same values as currently for tax purposes. Thus, depreciable properties would be valued at their historical costs net of capital cost allowances. Financial assets would be valued at their acquisition cost. Any appreciation in the value of properties would not be recognized in the

balance sheet until it had been realized for tax purposes. Deferred income plans, if they were included in the portfolio, would be assigned a value equal to the cumulative value of contributions.

Treatment of Private Corporations

As discussed earlier, if not all assets are subject to inflation adjustment a question arises as to how the indexing adjustment would apply when the ineligible assets are held through a corporation. Unless special provisions apply, indexing of corporate shares would effectively extend indexing to ineligible assets. While this effect would occur in both public and private corporations it would be of most concern in the latter case given the scope of individual control over private companies. One, and perhaps the only, solution to this problem would be to deny the application of indexing to private company shares directly. The indexing adjustment would be calculated on any eligible assets held by the company with the associated debt adjustment computed by using the company's debt-asset ratio. The resulting inflation adjustment would be allocated to the individual shareholders. They, in turn, would reduce the adjustment allocated to them by their own debt-asset ratio and add the resulting amount to the cost base of their shares in the company. There are at least two major difficulties with this approach.

First, allocation of the inflation adjustment, determined at the corporate level, to individual shareholders would inevitably be arbitrary wherever there are different classes of shares. Ideally this allocation should be in proportion to each shareholder's share in the assets of the company. In practice, it is extremely difficult to determine these proportions in a variety of circumstances.

Second, in the case of associated companies and chains of companies, the inflation adjustment would have to be flowed through to the ultimate individual shareholders. Each corporation in the chain would be required to calculate the indexing adjustment using its debt-asset ratio. Because a sequential application of the indexing adjustment would be different than that which would be determined on a consolidated basis, this would yield inaccurate results. The resulting inaccuracy would be greater the larger the number of corporations in the chain.

Special rules would also be required to determine the indexing adjustment when private company shares were disposed of in exchange for public company shares. Taxation of accrued capital gains on private company shares can be deferred through the use of a tax-free rollover provision. If private company shares were not to be indexed directly, as contemplated in the scheme above, it would be necessary to ensure that the indexing adjustment on the public company shares acquired in any exchange commenced only after the date of exchange, and was not retroactive to the original date of purchase of the private company shares. This would be relatively easy if the adjustment were made for each year separately. It would, however, be very complex to take into account such exchanges of property if the adjustment were delayed and computed in one step at the time of eventual sale.

Technical Issues

In implementing an inflation-adjustment scheme a number of technical issues would arise. Decisions on these sorts of issues would significantly affect the simplicity and practicability of any indexing scheme.

Date of Acquisition and Disposal of Property

For the calculation of indexing adjustments, the starting point is the date on which the asset was acquired, for it is the rate of inflation between the acquisition date and the date of disposal for which an inflation adjustment would be made.

The acquisition date, however, is not always simple to determine. Improvements to a property affecting the cost base might have been made at different times. Identical properties such as shares of a corporation might have been acquired at different times. Whereas at present a taxpayer is required to pool such properties and average their cost when sold, only an annual balance sheet adjustment type of indexing would permit such pooling. If not done each year, the result would be much greater record-keeping requirements for taxpayers and considerable administrative complexity. Property acquired at different times by an unincorporated business can be rolled over into a corporation in exchange for shares. When those shares are sold, under an indexing system there might have to be complex calculations based on acquisition costs of both the original and the replacement property.

Many of these problems could be avoided if the indexing adjustment were to be computed on an annual basis, though this in itself would require increased record keeping for taxpayers. Annual calculation would permit incorporation of improvements and new acquisitions of identical property into the computations as they occurred. In the absence of annual computation of the adjustment it could be extremely difficult for the tax authorities to verify, after a number of years, whether any asset sold had been held for the period indicated.

Surplus Stripping

The adjustment for inflation could lower tax on capital gains relative to dividends and could thus open up possibilities of tax abuse through surplus stripping, as described in earlier sections. As was discussed in detail there, this is a major issue and it is crucial to the equity and effectiveness of taxation of corporations and their shareholders.

Valuation Date

Any inflation adjustment should apply only in respect of inflation occurring after the introduction of the measure. For properties acquired in the past it would be necessary to determine the cost base to which indexing applied.

Ideally this base should be the value of the property on the date of introduction of the measure. An alternative would be to apply the adjustment to the original acquisition cost of the property. This alternative would under-compensate those whose property had appreciated in value between the date it was acquired and the date indexing started and over-compensate those whose properties had decreased in value. On the other hand, establishing a new value would be cumbersome for assets which are not regularly traded or are unique, such as real estate, private company shares, and art work. Transitional rules to the new system might be required.

Other Technical Issues

In implementing an inflation adjustment, decisions would also be required as to the price index to be used, the frequency with which the adjustment is made (annually, quarterly), the treatment of assets acquired or disposed of during the adjustment period, and similar matters. While such issues are important, and could affect the equity of the indexing adjustment, they do not pose insuperable technical difficulties.

Conclusions on Indexing Adjustment

In summary, indexing of capital gains is not straightforward. It is perhaps for this reason that no industrialized country has yet adopted a systematic indexing mechanism. This section of the paper has identified a number of important policy and technical issues. The

most important of these relates to the fact that inflation affects the measurement of not only capital gains but also other forms of investment and business income. There are no economic or tax policy reasons for singling out capital gains for inflation adjustment. In fact, because of various provisions under the current tax system the over-taxation of capital gains because of inflation is significantly less than for these other forms of income.

If, for some reason, it were decided to index capital gains in isolation, its scope would have to be severely restricted in order to prevent back-door indexing of other forms of income. Interest-earning assets and depreciable assets could not be eligible, nor could the adjustment apply directly to private company shareholdings. The indexing adjustment would have to be reduced where assets were financed by borrowing. It would be necessary to compute the adjustment each year based on a balance sheet, covering a wide range of assets and liabilities, submitted by each taxpayer owning eligible property. Even with this range of restrictions the indexing adjustment would not be accurate in a range of circumstances.

Tapering

Tapering is an alternative mechanism that is sometimes suggested as a method of providing inflation adjustment of capital gains. It involves including a smaller portion of a capital gain in taxable income the longer the asset has been held. For example, gains realized during the first year of ownership of a capital property might be fully taxable, with the proportion of gains included in income declining by, say, 10 percentage points each year thereafter. After a holding period of 10 years, gains would be completely exempt from tax, unless some maximum tapering adjustment were specified.

Table 14

Portions of Capital Appreciation Representing Real Gains for Selected Holding Periods

(1)	(2)	(3)	(4)	(5)	(6)
Years	Disposition Price	Total Capital Appreciation	Cost Base Adjusted for Inflation	Real Gain (2-4)	Portion of Capital Appreciation Representing a Real Gain (5-3)
		($)			(%)
0	10,000		10,000		
1	11,000	1,000	10,700	300	30.0
5	16,105	6,105	14,026	2,079	34.1
10	25,937	15,937	19,672	6,265	39.3
15	41,772	31,772	27,590	14,182	44.6
20	67,275	57,275	38,697	28,578	49.9
25	108,347	98,347	54,274	54,073	55.0

Note: The appreciation in the price of the asset is assumed to be 10 per cent per year. Prices are assumed to rise at 7 per cent per year.

Although there is often an impression that tapering is a less complex alternative to indexation, this is not the case. It suffers from many of the same problems as indexing, and would exacerbate other deficiencies in the capital gains tax system described below such as the lock-in effect. A further major objection to tapering is that it does not produce a reasonable approximation to taxation of real capital gains. Table 14 shows the ratio of real to total capital gain realized by an investor on a $10,000 asset which appreciates in value at 10 per cent a year while inflation is 7 per cent a year. It is clear that the ratio of real to nominal gains rises the longer the asset has been held. Thus, tapering is the opposite adjustment to that required for a true inflation adjustment. It effectively would result in an exemption of real capital gains. It is thus not a suitable mechanism for inflation adjustment.

Capital Losses

Currently, allowable capital losses are generally deductible against taxable capital gains and, for individuals, against up to $2,000 of other income. Capital losses on shares and debt of small business corporations are deductible against other sources of income without limit. Any unused losses may be carried forward indefinitely to be deducted in future, subject to the same limits. The question arises as to why, if gains are taxable, there should be a limit on the deductibility of losses against other income.

Conceptually, an accrued capital loss reduces a taxpayer's ability to pay taxes as do other losses. Restrictions on deductibility of losses thus can result in an unfair distribution of tax burden and can bias taxpayers against investing in risky assets, as the tax system is not neutral in its treatment of gains or losses. However, the taxation of capital gains is on a realization and not an accrual basis. Taxpayers thus have a great deal of flexibility in the timing of their transactions. They can very often choose when to realize accrued capital gains and losses. If there were no limit on the deductibility of realized losses, a taxpayer could realize a loss on a particular asset, thus reducing tax payable substantially, even though he had accrued but unrealized capital gains on other assets. This would open up avenues for undue tax reduction for those with significant holdings of capital properties that were not open to other taxpayers.

One possibility would be to allow taxpayers unlimited deduction for realized capital losses to the extent that they exceeded accrued, unrealized capital gains. Such a measure would improve the neutrality of the current tax system, but would require an annual valuation of all capital properties in any year in which the allowance was utilized.

Lock-in Effect

A lock-in occurs when taxpayers with assets which have appreciated in value hold on to those assets because no tax is payable on accrued gains. The advantages of deferring realization of accrued capital gains can be substantial. At an interest rate of 10 per cent, an extra year's deferral is equivalent to excluding a further 4 to 5 percentage points of the gain from tax. Investors may thus decide, for tax reasons, to continue holding an asset even though an alternative asset with a higher prospective yield is available. The lock-in effect inhibits reallocation of capital to where it can earn the highest return. The resulting misallocation of funds makes it more difficult for new firms to attract funds away from investments in established ventures.

Empirical evidence on the seriousness of the effect is not available. However, recent moves in Canada to permit tax-free inter-generational transfers of shares in small business corporations and incorporated farms have undoubtedly acted to increase the lock-in

effect. Without abandoning the taxation of capital gains, the only means of lessening the lock-in effect would be to move toward taxation of capital gains on an accrual basis, either annually or at some other fixed interval.

Liquidity and Bunching of Gains

In addition to the lock-in effect, two other issues are often identified. First, on a property held for several years, capital gains can accumulate to a substantial sum. When these gains are realized on disposition of the property, their taxation in the single year, the year of disposition, could push individuals into a higher tax bracket and the resulting tax would be higher than if the capital gains were brought into income over a number of years. This phenomenon, commonly referred to as the bunching effect, is a direct consequence of taxation of capital gains on a realization basis rather than an accrual basis.

The issue of bunching has been dealt with under the Canadian Income Tax Act through the provision of income averaging annuity contracts. Taxpayers may, through such annuity contracts spread the tax on capital gains over a number of years. Canada is the only O.E.C.D. country that provides such a flexible and generous mechanism for averaging the tax burden on capital gains. There are also other provisions which mitigate or reduce the adverse tax consequences of bunching of capital gains. Where payment is received in instalments, the taxation of gains may be spread over the full payment period. The provision for general averaging automatically operates to reduce the effective tax rate in years of abnormally high income, whatever its source. Of course, a large proportion of gains accrue to taxpayers in the top marginal rate bracket, who cannot be pushed into a higher tax bracket by any gain realized in the year.

One general type of solution of this problem, to the extent it exists, would be a move toward some form of accrual taxation, but this may not be practicable because of difficulties in valuation of properties.

The second issue relates to liquidity difficulties that arise when the timing of the payment of the tax on capital gains and the receipt of proceeds from disposition of property are not coincident. Taxation of capital gains on a realization basis, as opposed to on an accrual basis, does minimize the occurrence of such difficulties. There are, however, circumstances, when tax is payable on accrued capital gains even when there is no cash sale of the property or when the proceeds need to be reinvested immediately. These include relocation of a business, inter vivos transfer of farm property or small businesses among family members and deemed disposition at death. In these cases, the requirement for tax payments might require sale of business assets or loss of control of a family farm or business.

In response to these particular cases of liquidity problems, the government has introduced special provisions that allow assets to be rolled-over and taxation of capital gains deferred until a sale actually giving rise to liquid funds occurs. Transfers of capital property to a spouse do not lead to immediate taxation of capital gains. In 1977, a provision was introduced whereby taxation of capital gains is deferred where a replacement property of a similar type is purchased. Typical examples are the relocation of a business from a city centre or movement of a farm operation away from an expanding city. Inter-generational transfers of unincorporated farm property have been possible without taxation of capital gains since tax reform. This rollover was extended to shares in a family farm corporation in 1978. In that year, an inter-generational transfer deferring taxation of capital gains on up to $200,000 of accrued gains in a small business corporation was also introduced.

In these situations, gains are taxable only when the property is eventually sold outside the family or without a reinvestment in the business. At that time, funds will be available to pay tax obligations. It should be noted that while such rollovers and deferrals do serve a useful social and economic purpose, they result in reduction in the effective tax rate on capital gains.

Finally, in the case of deemed disposition at death, liquidity problems that might otherwise arise are mitigated by allowing taxpayers to remit tax in instalments over up to 10 years.

Selective Exemptions from Tax on Capital Gains

A number of proposals have been made for selective exemptions from taxation of capital gains. Examples include exempting gains on the shares of Canadian-controlled public corporations and gains on farm property.

The first concern in analyzing such proposals must be their appropriateness from the viewpoint of general economic and social policy. Any such proposals provide incentives for investors to place more of their savings in particular assets. This implies some withdrawal of funds from other areas. Can this reallocation of resources be justified as making a net contribution to economic growth, regional development, Canadian ownership or other desirable objectives? Is the tax system necessarily the most efficient instrument for providing such incentives? What are the consequences of such changes for the equity of the tax system? Any selective exemption will benefit certain taxpayers who are in a position to take advantage of it, or may provide windfall gains to those who have an existing interest in the economic activity selected. It could mean higher taxes for others. Are these effects justified? The fact that incentives for one activity mean less investment elsewhere and higher taxes for others is an important consideration in policy decisions as to the desirability of selective exemptions.

Beyond these concerns, there are some less obvious but very significant technical implications that would flow from the adoption of any such proposal. These implications can be placed in two broad groups. The first relates to the definitions and decisions which would need to be made to specify the scope of a partial exemption and fit it into the income tax system. This would inevitably introduce further complexities into the tax system and, for some proposals, a set of workable rules might not be possible. The second category relates to the interaction of the exemption with existing tax provisions. This interaction might lead the exemption to be broader than intended, and would require either coincidental changes in other tax provisions or the acceptance of leakages of tax revenue through tax avoidance. These considerations are set out in general terms below.

Difficulties Related to the Scope of Selective Exemptions

A selective exemption or tax reduction, by its very nature, requires the drawing of a line between eligible and ineligible activities of taxpayers. The workability, effectiveness and simplicity of any selective measure depends on the ease with which such lines can be drawn. In practice, accurate and fair separation between eligible and ineligible situations would not always be possible, given the wide range of real situations that exist, many of which may fall very close to any line that is drawn. Also, rules would often be required to deal with the treatment of taxpayers or activities during the transition to their new eligibility status. Following are some of the major issues that arise in providing selective exemptions from, or reductions of, tax on capital gains.

Defining Eligibility

Defining eligibility is by far the most difficult step because of the presence of numerous borderline cases under any chosen definition. Concepts such as farming, manufacturing,

common shares, public companies and private companies, while easily recognizable, are often hard to describe in the precise fashion required for tax legislation. For example, if relief were to be provided for shares of Canadian-controlled public companies, one would need to decide how Canadian control was to be determined. Should the relief apply to common shares only (voting, non-voting) or should it extend to preferred shares that are convertible into common, to all preferred shares, to rights, warrants, and income debentures? Would Canadian control be determined by 50-per-cent ownership of a class or classes of shares or would some other concept of effective control be necessary? How would the true beneficial ownership of shares be determined? This effective control test should take cognizance of the dispersion of shareholdings, the residence and/or nationality of the management and the characteristics of different classes of shares, and would inevitably require rules to look through registered shareholders to determine the ultimate shareholders.

Similarly, a selective measure for the farming sector would require definitions of farm property and an eligible farmer. What would be the treatment of a farm property which is also used for some other purpose, i.e., a piece of land temporarily in farm use pending development? Should the measure be confined to bona fide farmers or extended to anyone who happens to own farm property, i.e., hobby farmers, investors and developers holding undeveloped farm land? If the former, what criteria distinguish a bona fide farmer? One could consider such factors as the extent of personal interest in the operations, the number of years spent on the farm, or the proportion of income derived from farming. Some of these criteria cannot be applied for tax purposes as they cannot be quantified. Others are arbitrary and could result in genuine farmers being ineligible. For example, the proportion of an individual's income from farming varies from year to year depending on market and other conditions, and bona fide farmers may rent out their land to others for a period of time because of illness or retirement.

Change in Use or Status

Under the Canadian tax system, capital gains are generally brought into income only when the property is sold. The capital gains that are realized would generally have arisen over a number of years. If there were a selective exemption for property in certain uses and if the property had been employed in both eligible and ineligible uses, it would presumably be appropriate to have apportionment rules to determine what proportion of the realized gain was eligible for the exemption. In the absence of such rules there would be an incentive for taxpayers to convert the property to qualifying property before its disposition in order to qualify the entire gain for the special treatment.

Consider the example of capital gains tax relief for Canadian-controlled public company shares discussed previously. It is not uncommon for control of a corporation to change and corporations may change status from private to public and vice versa. A rule requiring the revaluation of a company's shares each time its status changed could present serious problems of administration and enforcement.

Treatment of Corporate Activities

Often, activities eligible for a selective tax measure will be carried on by both individuals and corporations, private and public. Tax equity would thus require that the benefits of a selective exemption be extended to individuals and corporations alike. However, including corporations in any measure magnifies the problems of defining eligibility outlined above. It would be extremely difficult, for example, to provide a partial exemption for the gain on a corporation's shares to the extent that it reflects underlying increases in the value of eligible property.

Valuation Day

Finally, given that capital gains are generally taxed when realized and not when accrued, a decision would have to be made as to the coming into force of a measure for selective exemption. The treatment of accrued gains from 1972, when the taxation of capital gains first became applicable, up to the date of implementation of the exemption would have to be determined. A full exemption for all gains would result in windfall benefits to those holding the exempt assets when the measure was introduced and would involve substantial revenue costs to the government. These windfalls could be significant given that capital assets are typically held for a number of years. Any such exemption would be resented by those who happened to sell their assets just before the effective date of the measure and thus were required to pay tax on the gains realized. To overcome these problems, eligible assets would have to be valued as of the date of the measure and only subsequent appreciation from that value would qualify for the exemption. Valuations are a difficult matter for assets which do not trade frequently. In order to ensure fairness, a new valuation day would require transitional rules similar to those needed in 1972 when capital gains were made taxable.

Interaction of Selective Exemptions with Existing Tax Provisions

Selective exemptions for capital gains would interact with the rollover provisions and the provisions affecting corporate surplus distributions.

The rollover rules could be used to broaden significantly the scope of capital gains tax relief for selected types of property or groups of taxpayers. For example, the income tax system provides for transfers of most property free of capital gains tax from a shareholder to a corporation. Tax is deferred until subsequent sale of the transferred property or the shares of the corporation. If capital gains on the sale of shares of corporations were tax-exempt, there would be an incentive to convert properties – that is, to transfer assets to a corporation in exchange for its shares, which could then be sold under tax-exempt circumstances.

Unless these conversion opportunities were curtailed, corporations could become intermediaries for the exchange of non-qualifying property for shares, thereby essentially broadening the exemption to encompass all capital gains. If the gains accrued to the time of transfer were to be taxed on the eventual sale of the shares, rules would be required to determine what portion of the shareholder's ultimate gain was taxable. The alternatives would be to deny the taxpayers the benefit of the current rollover provisions or to deny the exemption for shares received in a exchange of ineligible or non-qualifying property. While addressing tax avoidance possibilities, a denial of the rollover provisions could interfere with desirable business reorganizations.

As noted earlier, the new, enriched dividend tax credit, introduced in 1977, ensures that a large proportion of dividends are taxed at roughly the same rate as capital gains, i.e., at one-half of the normal rates on other sources of income. If this balance were to be disturbed through a selective or general measure for capital gains on shares, it could require reintroduction of rules to prevent unacceptable tax abuse by surplus stripping (artificial conversion of dividends into capital gains). Such rules, when they previously applied, were among the most complex in the tax system and hindered otherwise desirable corporate reorganizations.

In summary, a selective exemption could not be introduced in isolation without complex changes to the existing rules. If incentives are to be provided to certain sectors in the economy, it might be more efficient and simpler to do so through an expenditure program or a subsidized loan.

Conclusions

Taxation of capital gains is an important element of the income tax system. Capital gains add to a taxpayer's ability to pay. The question of whether such gains should be recognized in the determination of tax liability has important equity implications. Capital gains are concentrated among higher-income taxpayers and their taxation thus contributes to the progressivity of the individual income tax.

Taxation of capital gains plays an important role in the tax system itself. Without it, other features of the tax system would require change. This is particularly so in the corporation/shareholder tax area where the existing system can largely ignore the distinction between share gains and dividend distributions.

Taxation of capital gains is an important revenue source for the federal government and for provinces. Their revenue yield is estimated to be more than $1 billion in the current year. Their importance as a revenue source will grow in future as the system continues to mature. To eliminate the tax would require significant increases in other areas of taxation.

From various perspectives, the current tax treatment of capital gains is imperfect. Taxation of only half of capital gains, and other tax preferences that lower their effective rate of tax, are counter to the principle of tax equity, and to some extent result in misallocation of resources in Canada. On the other hand, the lack of proper inflation adjustment can cause an overstatement of true capital gains with the result that the tax can be levied on gains that are illusory. Taxation of gains when realized, rather than when accrued, induces taxpayers to continue holding a particular asset longer than may be economically desirable. This lock-in effect has undesirable implications for the efficiency of capital markets. The restrictions on the deductibility of capital losses against other income can produce a bias against risk-taking. The preferential treatment of capital gains, which necessitates a range of special tax provisions, results in complexity for both taxpayers and tax administrators. While these imperfections are well recognized, they are the outcome of the compromises among conflicting policy objectives that have been made in designing the system. A number of imperfections would be removed if Canada taxed all capital gains in full as accrued. This would enhance tax equity and neutrality, eliminate the lock-in effect and permit losses to be fully and immediately deductible. Taxing capital gains like other forms of income would reduce complexity, though periodic evaluation of certain assets to determine accrued gains would be a partially offsetting complication. Under such a system, there would be stronger justification for inflation adjustment of capital gains, assuming that such adjustment were technically feasible. However, when capital gains were first brought into income for tax purposes in 1972, the government rejected full taxation in order to provide incentives to Canadians to save and invest and to put them on roughly the same footing as foreigners investing in Canada. Also, capital gains on principal residences were not made subject to tax on social policy grounds.

Non-taxation of capital gains would not simplify the law nor appreciably ease the problem of administration and compliance. Indeed, capital gains cannot be exempted from tax in isolation: a major restructing of the whole of the Income Tax Act would be

required. The effective rates of tax on wealth in Canada are already the lowest among OECD countries. Given that the federal government and most of the provinces do not impose any taxes on wealth or estates, exemption of capital gains would leave Canada as the only industrialized country that permitted large amounts of wealth to be accumulated and to be passed between generations without any tax liabiliy. Also, there is no evidence that exempting capital gains would be a cost-effective method of promoting saving and investment or economic growth.

The current tax system does not distinguish between real capital gains and those which are purely nominal. Increases in the value of assets which merely keep pace with inflation in no way enhance the economic power of the asset holder and ought not, therefore, be subject to a tax on income. However, it must be recognized that the measurement of other forms of investment and business income are equally affected by inflation. To provide an inflation adjustment for capital gains could be regarded as discriminatory. In fact, capital gains do already enjoy significant tax preferences relative to other forms of income. In many cases these offset, or more than offset, the lack of explicit inflation adjustment.

Also, inflation adjustment of capital gains would not be straightforward. Simply indexing the cost base of capital property, and doing nothing else, would not be acceptable, both from the point of view of tax equity and economic efficiency. A proper inflation adjustment which took account of debt financing would be quite complex. It would require individual taxpayers to file a statement of their assets and liabilities each year. It could not apply directly to private company shares. Depreciable property and interest-earning assets would also have to be excluded from the adjustment. Even with these qualifications, the adjustment would not be accurate in a number of cases. It is for these reasons that no industrialized country has provided comprehensive inflation adjustment of capital gains or other investment or business income. If inflation adjustment of capital gains were to be provided, the rationale for their half-taxation would be weakened.

A number of suggestions have been put forward for selective exemptions from tax on capital gains. Such suggestions need to be analyzed in terms of their overall economic implications, their cost-effectiveness, their effect on government revenues, and thus the need for tax increases elsewhere. Exemptions can have important effects on the tax system that must be taken into account. Alternatives to tax exemptions, including grants or subsidized loans, may be more efficient in providing selective incentives.

Appendix I

Capital Gains Rollovers

One of the important objectives in the taxation of corporations and shareholders is to avoid unnecessary impediments to legitimate formations or reorganizations of corporations and partnerships. The rules to accomplish this generally defer the taxation of capital gains that arise in certain types of dispositions by allowing the accrued capital gain to be "rolled over" for recognition in a subsequent transaction.

Following are some of the important rollover provisions that permit corporations and their shareholders to defer taxation of capital gains:

The transfer of most business property such as inventories, depreciable assets and capital assets, such as shares, to a Canadian corporation in exchange for shares of the corporation. This rollover is widely used upon incorporation. It also enables many corporate reorganizations, including business consolidations and divisions, to be carried out on a tax-free basis. In essence it permits assets to be transferred to the corporation at their original cost rather than at fair market value, in order that no tax arises on the transfer.

The disposition by a shareholder of shares of an amalgamating Canadian corporation in exchange for shares of the new Canadian corporation. The shareholder is considered to have disposed of his shares of the amalgamating corporation at his original cost and to have acquired the shares of the new corporation at that same cost. Taxation of capital gains is deferred until subsequent sale.

The winding-up of a wholly-owned Canadian subsidiary corporation into its Canadian parent corporation. In this case, the parent corporation is deemed to have disposed of its shares in the subsidiary for proceeds equal to their adjusted cost base, thereby ensuring no immediate tax to the parent. Similarly, the subsidiary is deemed to have disposed of, and the parent is deemed to have acquired, the subsidiary's assets at their tax cost so that the transfer of assets does not result in taxation of the subsidiary.

The arm's-length exchange by a shareholder of his shares of a particular corporation in exchange for shares of a Canadian corporation under circumstances where the shareholder does not acquire control of the other corporation. This is an important rollover which facilitates take-overs. As with the amalgamation rollover, this provision allows the shareholder to treat the exchange as having been effected at his tax cost. The acquiring corporation is given a full fair market value tax cost on the shares provided it acquires an aggregate of at least 10 per cent of the corporation's shares.

A number of internal corporate share rearrangements such as share conversions and other reorganizations of a corporation's capital stock. These share exchanges and reorganizations can be effected without immediate tax consequences, and facilitate transactions ranging from estate freezes to reorganizations designed to improve the capital structure of businesses facing cash-flow or other problems.

Appendix II

Adjustment to Income for Depreciable Property Under Alternative Tax System

The text indicates that, unless restrictions were imposed upon the scope of capital gains indexing, it would not be possible to segregate effectively the inflation adjustment of capital gains from other forms of income. This appendix gives an example of this problem in the case of depreciable property.

Assume a depreciable property was bought for $100, that it has been allowed a depreciation rate of 20 per cent and is sold for $105. Inflation between the time of purchase and the sale of the property is 10 per cent. The table summarizes the adjustments to the taxpayer's income arising from the property under three alternatives: the current system, a system of indexing capital gains only, and a system of inflation accounting of both depreciation claims and capital gains. Under inflation adjustment of capital gains only, any sale of the property for a price between $80 (the undepreciated capital cost) and $100 would continue to result in a recapture of depreciation, any sale between $100 and $110 (the inflation-adjusted cost base) would result in a capital loss, and only sales for a price in excess of $110 would give rise to a capital gain. Under a system where both depreciation allowance and capital gains were indexed, sales for a price up to $110 would result in recapture of the depreciation, and sales in excess of this threshold would give rise to capital gains. As the table shows (line 8), neglecting differences arising from half-taxation of capital gains, these two systems would yield identical adjustments to taxpayers' incomes. In effect the inflation adjustment of capital gains becomes a substitute for inflation indexing of depreciation allowances. This is evident from the fact that the amount of capital loss under a system that indexed only capital gains is exactly equal to the amount of additional depreciation and capital gains. Furthermore, if only capital gains are indexed, there is an advantage for taxpayers to buy and sell depreciable property to establish a higher cost base for future depreciation purposes. Such transactions are generally not advantageous under the current system because of the tax consequences of recapture of depreciation and taxation of capital gains on an historic cost basis.

Table 15

Adjustment to Income for Depreciable Property Under Alternative Tax Systems

	Current System	Inflation Adjustment of Capital Gains Only	Inflation Adjustment of Depreciation & Capital Gains
		($)	
1 Historical cost	100	100	100
2 Inflation-adjusted cost	n/a	110	110
3 Depreciation at 20%	20	20	22
4 Undepreciated capital cost (UCC)	80	80	88
5 Sale price	105	105	105
6 Recapture of depreciation	20	20	17
7 Capital gain	5	−5	0
8 Adjustment to taxable income with full taxation of capital (line 6 + line 7 − line 3)	5	−5	−5
9 Adjustment to taxable income with half-taxation of capital gains (line 6 + half line 7 − line 3)	2.5	−2.5	−5

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