

# CAPITAL GAINS TAXATION: MARCHING (OH SO SLOWLY) INTO THE FUTURE

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"The source of one's income colours one's view of taxes."<sup>1</sup>

## I. Introduction

Recently, two major sets of changes have been made to the treatment of capital gains in the taxation system. The first, introduced in 1985,<sup>2</sup> enhanced considerably the preferential tax treatment already granted this income type.<sup>3</sup> The most recent witnessed a certain retrenchment by the government. Nonetheless, capital gains taxation has emerged secure, albeit slightly diminished, in its preferential status—much to the surprise of many onlookers of tax reform.

The first amendments were introduced on May 23, 1985, when the Right Honourable Michael Wilson laid before parliament one of the most surprising budgets seen since 1981.<sup>4</sup> Of particular surprise was the inclusion in the budget and subsequent enactment of a life-time exemption for capital gains of \$500,000.<sup>5</sup> This measure came as a shock to many staid economists and others concerned with fair and equitable tax reform. The measure was claimed to have been designed to "unleash the full entrepreneurial dynamism of individual Canadians."<sup>6</sup> Whether this is and will be the effect is debatable. It was certainly the advent of a new era in the checkered life of capital gains taxation. More recently, possibly concerned over revenue loss, the government retrenched. The recent *White Paper* caps the exemption at its 1987 level, \$100,000.<sup>7</sup> Moreover, undoubtedly spurred on by U.S. tax reform, capital gains in excess of this will be taxed in larger proportions.<sup>8</sup> In tax terms this represents an increase from 17% taxation to a top federal tax rate of 19% in 1988 and 22% in 1989. Farms and small business shares, with slight modifications, still qualify for the full \$500,000 exemption. Despite the backtracking, capital gains remains one

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1. L. Eisenstein, *The Ideologies of Taxation* (New York: Ronald Press, 1961) at 14.
2. *Notice of Ways and Means Motion to Amend the Income Tax Act*, tabled in Parliament, May 23, 1985.
3. Canada, *The White Paper on Tax Reform, June 18, 1987* (Ottawa: Department of Finance, 1987) (hereinafter *White Paper*, 1987).
4. The 1981 Budget introduced by The Right Honourable Mr. MacEachen created a storm of controversy which eventually led to many of the provisions being repealed.
5. *Income Tax Act*, S.C. 1970-71-72, c.63, as amended, s.110.6.
6. *Securing Economic Renewal: The Budget Speech*, delivered in the House of Commons by the Honourable Michael H. Wilson, Minister of Finance, Member of Parliament for Etobicoke Centre, May 23, 1985 (Ottawa: Department of Finance, 1985) at 6.
7. *Supra*, note 3 at 34.
8. *White Paper, 1987, ibid.*, proposes that two-thirds of the gain will be taxed in 1988 and three-quarters of the gain in 1989.

of the most prized forms of income from a tax perspective. The small increase in the amount subject to tax should not obscure this fact, for one must consider the advantages embodied in the following: the principal residence exemption;<sup>9</sup> the additional \$100,000 lifetime exemption;<sup>10</sup> the \$500,000 exemption for family farms and the shares of Canadian small business<sup>11</sup> and; the exemption of 1/3 (in 1988) and 1/4 (in 1989 and thereafter) of all excess capital gains.<sup>12</sup>

Together these exemptions represent an enormous subsidy by the tax-paying population for this type of income and significant revenue loss. The reasons for such favoured treatment obviously warrants careful investigation. This article will examine the historical evolution of the special preferential treatment given to capital gains, its past and present justification, and the role which it does and should play in today's economy and society. The reasons most often cited for the preferential treatment are carefully examined and evaluated and are, for the most part, found unconvincing.

## II. Historical Development

Income taxes were first introduced in England by Pitt in 1798 to finance the Napoleonic wars, and, as such, were discontinued in 1802; they were, however, quickly reintroduced in 1803, due to remaining hostilities. At the end of the war with France, taxes were reluctantly repealed because of their obvious unpopularity. A proposal to retain them "met with a storm of protests and petitions distinguished more by vehemence than by logic."<sup>13</sup>

The taxpayers' victory was shortlived. Recognizing its inability to govern effectively without sufficient revenues in the public coffers and much influenced by economists of the day,<sup>14</sup> Peels' government re-introduced taxes in 1842. The *Act*, based on its predecessors, specifically delineated in schedules the types of income subject to taxation. Increase in the value of capital assets was not among them. Thus, the division between capital and income gains was made at this early stage.

It is difficult to establish precisely the specific reason (or reasons) for the differentiation between "income" and "capital," but the bifurcation had taken place prior to the introduction of taxation. There is much support for the view that the division was adopted from property and trust law which required that types of property be differentiated to ensure fairness

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9. *Supra*, note 5, s.40(2)(b).

10. *Ibid.*, section 110.8 and *White Paper*, *supra*, note 3 at 34.

11. *Ibid.*

12. *Supra*, note 3 at 34.

13. M. Sabine, *A Short History of Taxation* (London: Butterworths 1960) at 119.

14. See, e.g., D. Ricardo, *The Principles of Political Economy and Taxation* (London: J.M. Dent & Sons, Ltd.; New York: E.P. Dutton & Co., 1912), originally published in 1817.

between the tenant for life and the remainder person.<sup>15</sup> Numerous court decisions defined and distinguished income arising from the estate (which would belong to the tenant for life) as against the value of the estate itself which would eventually come into the hands of the remainder person.<sup>16</sup> These distinctions were carried into taxation policy, reflecting both the social environment and no doubt the fact that the parliamentarians of the day were the landed gentry. England was an agrarian society in which land and the value of the land had been distinguished from the income which arose from it in the form of agricultural produce. In the *Wealth of Nations*, Adam Smith wrote in terms of wealth as "the annual yield to be derived from the property rather than the yield itself."<sup>17</sup>

Moreover, as Conway and Smith point out, land was not viewed as a commodity and was rarely sold:

The use of limited estates allowed for enjoyment limited to the ability to dispose of it. As the land could not be sold, it was regarded only as a source of his wealth and not itself as an item of his wealth.<sup>18</sup>

Consequently, land rose very little in value. As one historian comments: "the aggregate value of land in the 1800's remained in real money terms, about the same as it was ... in 1066."<sup>19</sup>

Nonetheless, this is not the complete story. It is interesting to note that one of the first forms of taxes was, in fact, a property tax. Two reasons have been suggested: first, property is readily identifiable and; second (and perhaps more importantly), one could not deny payment of taxes without disclaiming ownership.<sup>20</sup>

The reason for the decline of property taxes is instructive. Land taxes were widely avoided and much detested by landowners who, of course, were the voters and, more importantly, members of parliament. As the industrial revolution advanced and taxes could be raised elsewhere, the burden was increasingly moved from landowner to worker. This movement from property to income taxes ensured the continued privileged position attendant upon ownership of land. Accumulations of wealth would remain intact whilst the ability to accumulate was increasingly attacked by limiting taxation to those accumulating through income.

It is against this historical background in which the initial categorization of income and capital took place. In its social and cultural context, it probably made some sense. Today, the social and economic conditions are

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15. See G.R. Conway and J.G. Smith, *The Law Concerning Capital Gains* (Ottawa: Queen's Printer, 1967) (Studies of the Royal Commission on Taxation, no. 19B).

16. *Ibid.*, at 3.

17. A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Edinburgh: A. & C. Black, 1846), originally published in 1776.

18. *Supra*, note 15 at 4.

19. L.D. Stamp, *The Land of Britain: Its Use and Misuse*, 3rd ed., (London: Longmans, Green, 1962), quoted in D. Cohen, "The Relationship of Contractual Remedies to Political and Social Status: A Preliminary Inquiry" (1962) 32 *Univ. of Tor. L.J.* 31 at 37.

20. Sabine, *supra*, note 13, c. 7 and see M. Turner and D. Mills, eds., *Land and Property: The English Land Tax 1692-1832* (New York: St. Martins Press, 1968).

vastly different. The agricultural economy has been displaced by an industrialized one rapidly moving into a technological one in which information will become the most important form of property and, accordingly, the most important form of income. These types of income do not fit into the present fuzzy demarcations between income and capital. Continuing the historical bias no longer makes sense, if it ever did. Indeed, it may be antithetical to the aims towards which society, through its *Income Tax Act*, should be, and to a lesser degree is, moving.

In the U.S., the evolution of preferential status for capital gains followed a different path. Income taxation was first introduced by the *Revenue Act* of 1862 to finance the costs of the civil war. The *Act* imposed an income tax on "the annual gains, profits, or income of every person residing in the U.S. whether derived from any kind of property, rents, interest ...". After initial uncertainty, the courts held that, particularly in view of the word "annual," capital gains were not included in the taxing priorities.<sup>21</sup>

However, to meet concern over the constitutional right to tax, the sixteenth amendment was enacted to clarify and broaden the taxing powers.<sup>22</sup> As a result of these changes, the *Revenue Acts*, from 1913 through 1921 were interpreted as applying to capital gain in the same manner as any other income, culminating in the 1920 decision of *Eisner v. Macomber*,<sup>23</sup> where the Supreme Court of the United States stated unequivocally:

Income may be defined as the gain derived from capital, from labour, or from both combined, provided it be understood to include profits gained through a sale or conversion of capital assets ...<sup>24</sup>

The impetus that lay behind the movement to merge capital gain into taxable income was twofold. First, land was viewed very differently in the United States than it was in England, the U.S. subscribing to the quantum theory of capital, England to the res theory. Pragmatism played its part in this approach, as Marjorie Kornhauser indicates:

buying and selling of land was a common occurrence early in American history. Much of early American wealth derived from the sale of land whereas in England it came mainly from rents on stable long-held land.<sup>25</sup>

In a different context this was acknowledged by the U.S. courts:

The diversity ... between British practice and ours is undoubtedly founded in the permanent worth of their land as an old country, and the increasing worth of ours as a new country.<sup>26</sup>

21. For a full description of the evolution of income taxation in the United States see M. E. Kornhauser, "The Origins of Capital Gains Taxation: What's Law Got to Do With It?" (1986), 39 S.W.L.J. 869 and L. H. Seltzer, "Evolution of the Special Legal Status of Capital Gains Under the Income Tax" (1960), 3 Nat'l Tax J. 18.

22. The sixteenth amendment, ratified in 1913, states: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration." *U.S. Const. Amend. XVI*.

23. 252 U.S. 189 at 206, 64 Sup. Ct. Rep. 189 at 192, 64 L Ed. 521 at 527 (1920).

24. *Ibid.*, at 207, 193 and 528, respectively.

25. *Supra*, note 21 at 888.

26. *Honsford v. Waight* 1 Kirby 3 (Conn. 1786), quoted by Cohen, *supra*, note 19 at 37

If revenue was to be raised, it would have to include one of the most profitable sources, that of gain on sale of land. It may also have been more acceptable to tax land in the U.S. than in England because it played a very different role in the social structure at the time. Seltzer takes up this point:

Land was so plentiful and cheap that its ownership did not carry the same social prestige that it did abroad. The strong desire to keep the descent of land ownership along family lines that was so conspicuous in Europe was relatively weak in [the U.S.].<sup>27</sup>

The second reason was more often expressly articulated in the court cases: the need for revenues. For example, in *Merchants' Loan and Trust Co. v. Smietanka*<sup>28</sup> one of the main arguments put forward in favour of capital gains taxation was a plea for money. If there was an adverse ruling, a large source of revenue for the government would be destroyed, which could have had severe consequences for the finances of the country.

Full taxation of capital gains was short-lived. Many complaints were heard that capital gains taxation had the effect of creating a stagnant market. No one would sell assets for fear of attracting taxes. In 1921, the legislature introduced preferential treatment for long-term capital gains in the hope and expectation that it would produce increased sales in property.<sup>29</sup> Long term gains, defined as those assets held for at least two years, were, at the option of the taxpayer, taxed at a flat rate of 12.5% or added to taxable income. Following criticisms that such legislation encouraged people to hold onto assets that had appreciated in value for two years and to sell those which had depreciated within two years (to utilize the more generous loss provisions), the legislation was amended in the *Revenue Act of 1934*.<sup>30</sup> A step-up plan was introduced based on a percentage inclusion of gains and losses related to the length of holding. With various amendments this pattern has continued until the recent reforms, although it has, on occasion, been roundly criticized.<sup>31</sup>

Recently, the wheel has come full circle with the major Tax Reform Bill passed by congress on the initiation of U.S. President Ronald Reagan.<sup>32</sup> Capital gains are now once again subject to tax at the same rates as other types of income.<sup>33</sup> The abolition of the preferential treatment was secured politically by a substantial reduction in the tax rates on all other types of income. However, in the event that these concessions are lost, (for example, by future rate increases), the preferential treatment for capital gains will be reintroduced. To facilitate easy reinstatement, the distinc-

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27. *Supra*, note 21 at 22.

28. 255 U.S. 509, 65 L. d. 751, 41 Sup. Ct. Rep. 386 (1921).

29. *Revenue Act of 1921*, 67th Congress, Sess. I, ch. 136, 1921, s.206.

30. *Revenue Act of 1934*, 73d Congress, Sess. II, ch. 277, May 10, 1934, s.117.

31. See, e.g., S. Surrey, "Definitional Problems in Capital Gains Taxation," *Tax Revision Compendium*, vol. 2 at 1203.

32. *Tax Reform Act of 1984*, 98th Congress, ch.369, S.5.

33. *Ibid.*, s.301.

tions between capital and income remain intact (although currently redundant) in the *Revenue Act* of 1986.<sup>34</sup>

England has also changed its tax treatment of capital gains. In 1955, an English Royal Commission was set up to investigate the taxation of profits and income.<sup>35</sup> It issued its final report in 1955, wherein the majority report of the Commission came out strongly against the taxation of capital gains. This decision was greatly influenced by the acceptance of evidence of adverse consequences that would flow to the Stock Exchange and savings if capital gains were to be taxed. A strong minority report, however, urged that capital gains should be taxed, that England should move towards a more comprehensive tax base, and that the concept of income should be broadened to include, in effect, the Haig-Simmons<sup>36</sup> definition of income as the "net accretion to economic power," which would, of necessity, include capital gains.

The majority report was accepted by the government of that time and nothing further was done with respect to capital gains. As the economic structure of society advanced, the distinction between capital and income became, and continues to be, increasingly obscure. At both ends of the spectrum the division may be clear, but for the vast majority of income it has become a fiction, to be made into reality by the courts at great expense.

Only ten years after the report was produced, the government felt that it was necessary to introduce capital gains taxation in England. Conway and Smith attribute this to the fact that "the social, economic and political climate was such that the government felt constrained to introduce such legislation."<sup>37</sup> At this point the obvious question that must be raised is: What was the particular social and economic climate of England which made it so different from Canada then—and indeed from Canada today—so as to justify the continued preferential treatment accorded to capital gains?

### A. The Present Regime of Capital Gains Taxation

Why then was the distinction between capital and income adopted and maintained in Canada? What theories and justifications emerged to ensure its continuing preferential status? Interestingly, the first *Income Tax Act* in Canada borrowed heavily from its U.S. counterpart, rejecting the scheduled system of England and adopting what at first glance appeared to be a broad concept of income.<sup>38</sup> Although there was enumeration of particular sources, income could be from any source. However, the *Act* did not

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34. See the *Internal Revenue Code*, 1986, section 1222. See also *Tax Reform Act of 1986: Conference Committee Report Cmmd. 9474* at II-107 and R.L. Gardner and D.N. Stewart, "Capital Gains and Losses After the *Tax Reform Act* of 1986," (1987) *Taxes* 125.

35. Royal Commission on The Taxation of Profits and Income, *Report* (Cmmd. 9474).

36. R.M. Haig, "The Concept of Income — Economic and Legal Aspects" in R.M. Haig, ed., *The Federal Income Tax* (New York, 1921) at 59.

37. *Supra*, note 15 at 27.

38. *Income War Tax Act*, R.S. 1917, c.28, s.3.

specifically adopt the all-encompassing view of income prevalent in the United States at that time. Instead, the decision was left to the courts, who came down firmly in favour of the distinction between income and capital. This arose, in part, because the Canadian judiciary followed English decisions; the Privy Council was still the highest court of appeal for Canada. Accordingly, crucial parts of the Canadian Act, including the notion of income, were defined by reference to the English cases, which specifically excluded all notion of capital gain from the meaning of "income." This notion became so firmly entrenched that when the *Canadian Income Tax Act* underwent a major review in 1947, the possibility of imposing tax on capital gains was not even raised.<sup>39</sup> Unlike the English Act, the Canadian Act continued to allow for the possibility of the creation of new sources of income by a catch-all phrase: "from any other source."<sup>40</sup>

This broad approach remains to this day, although it continues to be utilized sparingly by the courts and has never been used (nor was it intended to be used) to bring capital gains within its net. The reasons for the initial exclusion of capital gains remains unclear. Analysis of the nature of land when taxes were first introduced in 1917 reveals that, like the U.S., it was considered a commodity and subject to rapid price increases.<sup>41</sup> To explain this phenomenon as a slavish adherence to English precedent or the power of the land owning class would be simplistic. Yet capital gains continued to elude the coffers of the treasury.

Until 1972, capital gains remained completely exempt from any form of taxation except indirectly, as a result of the imposition of estate taxation levied by the provinces. In 1965 the Royal Commission on Taxation<sup>42</sup> (the Carter Commission) was set up to enquire into the tax system. Their report was issued in 1967. Included in this thoughtful and comprehensive report was a strong recommendation to tax capital gains fully.<sup>43</sup> The recommendation was predicated upon some important provisos: in particular, that there should be liberal averaging provisions, a top marginal tax rate of 50% and unlimited carry-forward of losses and, perhaps more significantly, an unlimited carry-forward against all types of income. Recognizing the radical nature of this recommendation, generous ameliorating provisions were included to lessen the impact of the tax. Despite these compromise provisions, this recommendation, perhaps more than any other, met with fierce criticism.<sup>44</sup> It was approved and adopted in the gov-

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39. *An Act to Amend the Income War Tax Act, 1947, c.63.*

40. *Ibid.*, s.3.

41. Cohen, *supra*, note 19 at 38.

42. Royal Commission on Taxation, *Report* (Ottawa: The Queen's Printer, 1967) (hereinafter referred to as "The Carter Commission").

43. *Ibid.*, vol. II, at 251.

44. See, e.g., I.H. Asper, *The Benson Iceberg: A Critical Analysis of the White Paper on Tax Reform in Canada*, (Toronto: Clarke, Irwin, 1970). Compare the irrational comments of H.O. Spindler, "Capital Gains: Equality, Economics and Emotion," in *Report of Proceedings of the Twentieth Tax Conference convened by the Canadian Tax Foundation, November 1967* (Toronto: The Foundation, 1968) at 348, who, commenting on the proposal by the Commission to fully tax capital gains concludes at 348: "[i]t is probably fair, rational and even inevitable. And yet somehow it's rape" and papers therein by G.T. Tamaki (at 348), J.G. MacDonald (at 353) and P.N. Thorsteinsson (at 357).

ernment's *White Paper on Tax Reform* published two years later.<sup>45</sup> However, in an attempt to moot some criticism, the *White Paper* recommended that the gains on publicly traded shares should only be taxed on one half of the gain. As in the Carter Report, tax was to be levied on a realization basis and not on an accrual basis. To avoid lengthy and unwarranted deferral of taxation on publicly traded shares, the government proposed a five year deemed disposition rule. There were complicated grandparenting provisions.

When the *Income Tax Act* of 1972 was finally enacted, these recommendations were considerably watered down.<sup>46</sup> Only one-half of gains occurring on all types of capital property were to be subject to taxation.<sup>47</sup> Imposition of the tax was to be at the time of disposal of the property; there were to be no five year deeming provisions, thus giving a large latitude in tax planning in terms of tax deferral and planned dispositions in appropriate years. Various exemptions were included and numerous provisions enacted to avoid undue hardship. For example, generous averaging provisions were included to avoid the harsh tax consequences caused by the bunching of capital gains income in the year of disposition even though the gains had accrued over a number of years. Complicated grandparenting provisions were also enacted to ensure that any gain accrued prior to 1972 would be tax free.<sup>48</sup>

In 1985, the provisions were amended again to allow capital gains further favourable tax treatment.<sup>49</sup> The first \$500,000 of gains made on the disposition of capital assets were to be exempt. The exemption applied during a lifetime and contained no restrictions on the types of assets which qualified, but did restrict those able to utilize it to individuals other than trusts. These provisions greatly increased the complexity of the *Income Tax Act*.

Needless to say, the provisions have not been without critics.<sup>50</sup> Without doubt, they fly in the face of ability-to-pay principles, distorting horizontal and vertical equity in favour of capital asset holders. Inequity is increased and the possibility of tax avoidance enhanced considerably, adding new dimensions to aggressive tax planning. Already a plethora of articles exhort and illustrate how to make optimum use of the provisions<sup>51</sup> (provided, of course, that a taxpayer has the funds to utilize them and, moreover, pay the legal and accounting fees). What is or is not capital is of

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45. Canada, *The White Paper on Tax Reform, November 7, 1969* (Ottawa: Department of Finance, 1969).

46. *Supra*, note 5.

47. *Ibid.*, ss.38-40.

48. *The Income Tax Application Rules, 1971*, enacted as Part III of c.63, S.C., 1970-71-72, s.26.

49. *Supra*, note 5, s.110.6.

50. W.R. Lawlor, "Surplus Stripping and Other Planning Opportunities with the New \$500,000 Capital Gains Exemption" (1986), 34 Can. Tax J. 49.

51. See, e.g., R.J. Dawe and D.W. Smith, "Estate Planning: A New Era" (1986), 34 Can. Tax J. 1. For example, one scheme proposed entails transferring funds to a terminally ill spouse who has not used the exemption fully; the property will then revert to the live spouse after death. See Catherine Brown, *Conference Proceedings* (Canadian Tax Foundation, 1987) (forthcoming).



prime importance again, adding considerably to the likelihood of increased litigation. Lawlor sums up the more pressing criticisms:

Its definition of eligible assets is too large. It largely destroys the integration between the corporate and personal tax system. It also invites too much gamesmanship which, when publicized, will bring a disrespect to the overall system that cannot be tolerated in a self-assessment tax system.<sup>52</sup>

Obviously, such a scheme will result in considerable loss of revenue and distort the notion of ability to pay. Although the government recently reduced the amount of the exemption to \$100,000, it cannot silence the criticism. The amendment may have lessened the enormity of the subsidy, but the substance and ideology remains intact. Why, at a time of major tax reform, was the opportunity not grasped to rid the tax system of the capricious and arbitrary distinction between capital and income? Why the need to compensate for every small reform—in this case, a \$100,000 exemption in lieu of an increase in 25% of the portion of gain eventually to be taxed? What justifications have been and can be put forward to bolster the continued preferential treatment for capital gains?

### III: The Advantages of Capital Gains Preferential Taxation

Despite the amount that has been written on the issue of capital gains taxation, there are few empirically verifiable arguments that preferential treatment for capital income is necessary to enhance economic and social development. Most arguments revolve around equity, economic efficiency and administrative simplicity. A further heading, less often explicitly addressed but nevertheless very influential in determining the treatment of capital gains, is political expediency. Under economic efficiency fall concerns relating to inflation, incentive to business, and foreign investment. Equity encompasses those concerns relating to inflation, bunching and double taxation, whilst administrative efficiency covers implementation and enforcement. Political expediency is self-evident.

#### A. Equitable Considerations

##### 1. Inflation

Capital gains, it is most often argued, should be given preferential treatment over other types of income because capital income suffers most in periods of high inflation. When assets are eventually sold, the rise in value may be solely or partly attributable to inflation. Therefore no "real" gain exists and it is unfair to tax fictitious gain. Putting the case more forcefully, Asper<sup>53</sup> comments that because "a capital gains tax is often a tax on inflation" it is "intolerable." Assets held for a long period rise in value partly or indeed solely due to the inflation experienced during the holding

52. *Supra*, note 50 at 53.

53. *Supra*, note 44 at 97.

period. The increase in gain, therefore, may have little, if anything, to do with real growth or real appreciation. Inflation increases effective tax burdens and distributes them at best capriciously, and, at worst, in a regressive manner.<sup>54</sup>

Such a straightforward assertion should be easily verifiable. Yet this is not the case. There is conflicting empirical evidence. One study concluded by Felstein and Stemrod<sup>55</sup> in 1973 backs up Asper's claims. In this study, it was estimated that individuals paid nearly 500 million dollars of extra tax on capital gains arising on corporate stock due entirely to the distorting effect of inflation. The distortion was greatest for middle income sellers of corporate stock. On this evidence, the rise in value certainly did not represent an increase in the taxpayer's command over goods and services. If substantiated, such data may militate in favour of some type of preferential treatment.

Even so, a number of responses can be made to counter a claim based on the effects of inflation. One obvious response is that all types of income, not just capital income, are affected by inflation. Wage increases are granted which have little real gain associated with them and can be attributable solely to inflation. High interest rates, for example, are often a result of inflation representing little pure gain.

Insofar as arguments in favour of preferential treatment rest on the effects of inflation they can be made, and should be made, for all types of income. Indeed, they can be made more forcibly for other types of income. Many types of income do not rise in inflationary periods, for example, fixed pensions, annuities or government bonds. Those who have increased gains, even insofar as they are attributable to inflation, do have an increase in economic wealth on a relative basis. Accordingly they are more suitable as subjects of taxation. Furthermore, as Andrew Alston points out, the arguments regarding inflation "presuppose that one of the functions of the income tax system is to maintain the real value of assets in times of inflation."<sup>56</sup> This has never been the case; quite the reverse. The *Income Tax Act* often deliberately functions as a curb to spiraling inflation. Conway takes up this point in the following extract:

... [S]ome taxpayers acquire certain kinds of property (equities, some land) in anticipation of inflation. Stock markets are noticeably buoyant when expectations of inflation were widespread. The speculative profits that result would appear to be an excellent subject of taxation, rather than a reason for exemption.<sup>57</sup>

54. Although in the text I take this argument at face value, I have some conceptual difficulties with it. Presumably, when capital is converted to money all taxpayers are in the same dilemma regarding inflation. What people choose to buy with their money is irrelevant to the tax system. If people choose to invest in capital investments which are (for the sake of argument) more severely affected by inflation, presumably they made a bad investment. If money is to be attracted into that sector again, the market will adjust its prices to take into account the invidious side effect of inflation. The taxation system should remain neutral.

55. Felstein and Stemrod, "Inflation and Excess Taxation of Capital Gains on Corporate Stock" (1978), 31 *Nat'l Tax J.* 107.

56. A. Alston, "Should We Have a Capital Gains Tax?" (1961), 9 *N.Z.U.L. Rev.* 257 at 265.

57. G.R. Conway, *The Taxation of Capital Gains* (Ottawa: Queen's Printer, 1967) (Studies of the Royal Commission on Taxation, no.19) at 69.

Counter-arguments emphasize the accentuated effect of inflation on capital assets. Wages and, if desired, interest income are reported on an annual basis and hence the effect of inflation on these types of income is lessened considerably. In particular, as Asper points out:

the person receiving his income on an annual basis is consuming goods and services on an annual basis, and therefore does not have the huge build-up of tax to pay at, say, 1989 rates, on 1969 dollars.<sup>58</sup>

Inflation works more individually over the long term and, in a progressive taxation system, affects considerably the amount of tax payable. This discrepancy is increased by the fact that the present *Income Tax Act* provides some recognition of the effect of inflation on yearly income by its extensive and relatively generous indexing provisions.<sup>59</sup>

Whether these concerns relating to the damaging impact of inflation on capital assets relative to other types of income are well-founded is open to some debate. There is strong empirical evidence to the contrary. For example, Bucovetsky remarks that, at least in the case of common shares,

there is substantial evidence that, given a sufficient period of adjustment, common stocks do maintain their real value after long periods of currency depreciation.<sup>60</sup>

Conway has reached similar conclusions, albeit with the proviso that it mattered greatly in which year the shares were held. Assets purchased in 1927 or 1937 were significantly affected by inflation whereas for assets purchased at most other times, the effects of inflation were relatively minor.<sup>61</sup>

Although these studies suggest that the impact is not as great as often estimated, undoubtedly some assets are affected by inflation. Even so, this might simply mean that the taxpayer has made a bad investment. The option is always open to her to sell and buy another less affected investment. And even if it were desirable to take an inflation-induced gain into account in the taxation system, it is unlikely that the present or past method of preferential treatment meets this objective. Although there is disagreement as to the extent of the affect of inflation, all of the studies illustrate that there is no direct correlation between the length of the holding period and the size of the inflation factor. Given this, discrepancies could be alleviated in a manner that is more appropriate, more fair and more effective.

The present preferential treatment is an extremely crude and, moreover, inequitable method of dealing with the problems. It is heavily weighted in favour of, and therefore encourages, quick disposal or turnover of capital assets. The shorter the time assets are held, the less affected they are by inflation. Yet they will still receive full benefit of the favourable tax treatment. Similarly, all assets receive favourable tax treatment regard-

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58. *Supra*, note 44 at 96.

59. *Supra*, note 5, s.117.1.

60. M.W. Bucovetsky, "Inflation and the Personal Tax Base: The Capital Gains Issue" (1977), 25 *Can. Tax J.* 79 at 84.

61. *Supra*, note 57 at 73-76 and the tables therein.

less of how they have been affected by inflation, although it is obvious that inflation hits some assets considerably more than others. For example, works of art are much less likely to be affected by inflationary gains than land would be. The *Income Tax Act* does not differentiate between various types of asset and does not take into account the length of holding—crucial variables in the inflation game. Not surprisingly perhaps, the administrative difficulty in doing so would make such a scheme unthinkable and unworkable. One alternative would be to index capital assets at the rate of inflation per year, but only to the extent that other types of income are indexed or granted some allowance. While not a foolproof remedy (as inflation will still hit some assets far more than others), it would be a considerable improvement on the current system. If some allowance is to be made for the effects of inflation on capital assets, this is the most appropriate.

Good arguments can, however, be made that there is no need to compensate the owners of capital assets for the impact of inflation in any manner. They are already adequately, and perhaps overly, compensated (even disregarding for the moment the present 50% reduction and the newly added additional \$100,000 lifetime exemption) due to the deferral of tax liabilities. Deferral possibilities arise because capital gains tax only becomes due in the year of the disposition of the asset. Owners of capital assets are able to elect in which year they will pay taxes and thus can minimize the tax consequences. Combined with the proposals outlined below in respect to bunching, this factor more than compensates for any losses suffered over and above those relating to other types of income.

Refusing to index capital gains might have a beneficial secondary effect: it may reduce the possibility of locked-in assets. The "locked-in" effect occurs when a taxpayer becomes unwilling to sell her capital assets because disposition will attract tax resulting in a restricted market. Introducing some form of indexing would lessen the danger of this happening because, as Bucovetsky points out:

under full taxation of realized real gains, if an asset is sold and proceeds used to purchase another, the basic compensation for future inflation will be applied to the net-of-tax price of the current holding. The alternative—retaining the current portfolio—would attract compensation for future inflation only on original asset cost, a smaller number than the net-of-tax sale price.<sup>62</sup>

Finally, notions of distributive justice can be used to justify full taxation of capital gains without any form of indexing being required to take into account inflation. Those hit the hardest by inflationary gains on capital assets will be the people who can most afford it, producing, in effect, an equitable redistribution of income and property. Even Bucovetsky, an advocate of inflation indexing, acknowledges the strength of this argument, conceding that "since justification for indexing is essentially an equity argument we require the prior assumption that the resulting distribution of

62. *Supra*, note 60 at 90.

income and wealth corresponds to the preferences of society.”<sup>63</sup> Conway answers this by remarking that “full taxation of inflationary gains, rather than being inequitable would in fact contribute to equity by mitigating the redistribution of income and capital that would otherwise result from inflation.” Yet the persistence with which the inflation argument is made suggests that this may indeed be the reason for the preferential treatment of capital assets. Those hardest hit by inflation are the wealthy; the items hardest hit, property. Compensation is therefore made in the *Income Tax Act* to prevent the danger of loss of assets or wealth in highly inflationary times.

There are also more practical considerations for resisting any scheme which would take into account inflation in capital assets. In particular, there is real difficulty in ascertaining with any certainty the amount of inflation which has affected any specific asset or type of income. In addition, and perhaps more compellingly from a revenue perspective, it could result in enormous losses. If inflation were to be factored in, a taxpayer could claim a deductible loss in the event that the inflation factor pushed the asset price below the adjusted cost base.

## 2. Bunching

Similar considerations arise with another argument put forward in favour of the preferential treatment for capital gains: such treatment is justifiable, at least in part, because it alleviates the unfair tax result that arises in the year of disposition. At this time all the accrued gains have to be brought into account for tax purposes (subject to allowance for reserves in the case of installment payments). Imposition of tax only arises when the capital asset is sold or otherwise disposed of, which results in higher taxes being payable as the taxpayer is pushed into the higher income tax brackets in the progressive rate structure.

A flat rate taxation schedule would not create any difficulty: the rate would remain constant regardless of the profit made. With the recent movement towards lower and fewer rate scales this problem is much reduced, although not eliminated. A flat tax rate could be levied on capital gains only, but this would still result in inequities, discriminating in favour of the rich taxpayer. Not only would the wealthy taxpayer receive lower rates on this income type, non-capital tax rates would probably be increased to make up for the lost revenues. Raising other taxes is far more likely to have a greater impact on the less wealthy taxpayer. Furthermore, a flat rate tax on capital gains is inequitable even if both rich and poor taxpayers realize capital gains. The rich taxpayer would pay taxes at the flat rate, which would be less than the rate that would have been paid if added to her income on a progressive tax scale, yet the poorer taxpayer would probably pay taxes at a higher rate on capital gains than if the gains had been added to her income.

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63. *Ibid.*, at 80.

Even if these additional problems did not exist, the present treatment would be a less than adequate approach. Taxation of one-half of the gains realized is an unsuitable and arbitrary solution. A more appropriate approach would be to value and tax the appreciation in gain on a yearly basis. By far the most theoretically sound approach, it is open to criticism, for even if annual valuation proved feasible, the administrative costs would be considerable.

Legitimate concerns would be expressed over taxpayers' cash liquidity because of the requirement to pay taxes on capital appreciation even though the items have not been sold or the gain realized. However, it is hard to rationalize why a tax system which prevents a taxpayer from accumulating assets in the first place should be preferred over one which taxes them once accumulated.<sup>64</sup>

One way to minimize these concerns would be to give the taxpayer the choice of yearly taxation on an accrual basis or taxation on a realization basis. Yearly taxation would minimize the incentive to retain assets and, accordingly, alleviate concerns that a system which only taxed on disposal might have the effect of "locking-in" assets, as people would be reluctant to sell because of the taxes which would be attracted, thus putting a damper on the market. There would be great temptations to "sit out" the taxing government until a more conservative and, accordingly, more sympathetic government was elected (there is some evidence that this happened in England in 1965, when capital gains taxation was first introduced). To provide a penal incentive for the accrual method, interest could be levied on the unpaid taxes for taxpayers wishing to pay on a realization basis. This would equalize the treatment between taxpayers choosing different options. It would also provide compensation to the government for the hitherto interest-free loan given by the government to the taxpayer working on a realization basis. There would also be important secondary benefits. Any incentive to lock-in assets, without the possibility of forcing an unwanted sale on the taxpayer to pay the taxes, would be considerably reduced. Equity would be increased by placing the capital gains income earner on a more equal footing with taxpayers who are obliged to pay taxes on a yearly basis or suffer late payment interest payments (and penalties).

These, then, are the two main "equitable" reasons for allowing the present regime of preferential treatment to continue. Both have been shown to be more adequately dealt with by other taxation measures better suited to meet the particular concerns raised. I will now turn to the more ideological and, accordingly, more pressing reasons which have been put forward by the proponents of preferential tax treatment for capital gains, economic efficiency gains.

## **B. Economic Efficiency**

The reason put forward most often by advocates of favourable tax treatment for capital dispositions can be stated simply: reducing the tax on

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64. See A. Gun, "The Case for an Income Tax" (1978-79), 46 U. Chi. L. Rev. 370 at 381.

capital assets encourages and stimulates people to invest in Canadian assets and companies. Canada is said to be a nation of risk-averse savers and strong measures are needed to entice taxpayers into risky investments. Therefore, the main justification for the introduction of the \$500,000 exemption was that it would encourage risk-takers or, to quote Mr. Wilson once again, "unleash the entrepreneurial dynamism of Canadians."<sup>65</sup> The recent decision to expedite the \$500,000 exemption for small businesses is similarly justified.<sup>66</sup>

Although not often clearly articulated, yet always underlying the discussions advocating favourable tax treatment, there are also concerns that preferential treatment must be given to enable Canada to remain competitive in world markets generally, and in the United States market in particular. These concerns will be taken in turn.

### 1. Stimulating business

Canadians are conservative savers and, to encourage them to become bold investors, it is necessary to give large incentives. This point is taken up by John Bossons, who comments that the evidence implies that "the major potential economic impact [of increased personal income taxes] is on the volume of personal savings ..."<sup>67</sup>

A number of points are raised by these arguments. It is certainly true that Canadians are a nation of savers; statistical evidence<sup>68</sup> clearly bears this out. In 1984 Canadians saved 13.1% of their personal disposable income compared to a saving rate of only 6.3% for Americans. The figures are even higher for previous years; Canadians saved 15.3% in 1983, 15.2% in 1982 and 14.2% in 1981. Americans remained consistently low at 5.4% in 1983, 6.8% in 1982 and 7.1% in 1981.

Moreover, there is some evidence that the preferential treatment of capital gains does have a negative effect on aggregate personal savings.<sup>69</sup> It is less clear why this is considered a national deficiency and not merely an indication that Canadians are not inherent risk-takers. Saving money is not in itself a bad thing. It ensures that future generations are protected, a goal most liberals would endorse. For example, it would be in keeping with the principle of just savings that John Rawls envisions people in his original state would subscribe to, in order to protect future generations.<sup>70</sup> As

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65. *Supra*, note 6 at 6.

66. See *White Paper, 1987, supra*, note 3 at 10, where Mr. Wilson's comments that the preferential treatment is "a reflection of the importance of small business, the need to encourage people into a risky environment ..."

67. See, e.g., J. Bossons (1981), 29 *Can. Tax J.* 809 at 821.

68. See Statistics Canada, *National Accounts and Expenditures* (Ottawa: Minister of Supply and Services Canada, 1986) at 6, Table 5, and U.S. Department of Commerce and Bureau of the Census, *Statistical Abstract of the United States 1987*, (Washington: Department of Commerce, 1987) at 423, Table No. 711.

69. See J. Bossons, "Implementing Capital Gains Tax Reforms" (1979), 27 *Can. Tax J.* 145. However, empirical evidence cited by Pamela Gann, "Neutral Taxation of Capital Income: An Achievable Goal?" (1985), 48 *Law & Contemp. Probs.* 77 at 90, suggests that this is not the case.

70. J. Rawls, *A Theory of Justice* (Cambridge, Mass.: Belknap Press of Harvard University Press, 1971).

well, to the extent that saving money consists of placing money in banks or in government institutions, it may also help the economy by providing funds which banks and governments can invest in business enterprises, either as shareholders or creditors. There are, admittedly, a number of reasons why this form of indirect investment may not be as economically efficient as direct participation. In particular, because agents are introduced, there may be more associated costs in obtaining the loans, which would translate into higher interest rates. Perhaps there would also be a reduced market for these funds, as they would be strictly controlled by the investment criteria used by the major institutions and limited by an inherent and statutory bias for safe investments and large corporations.<sup>71</sup> Yet, ironically, it could mean greater access for private companies who have few other outlets in which to raise capital.

Even if the lack of risky investment is a legitimate complaint, the present regime of taxation is unlikely to provide a solution. Indeed, it may exacerbate it. Encouraging taxpayers to place money in capital assets, of any type and anywhere, does little to enhance risk-taking. If the capital investments encouraged by the favourable treatment of capital gains (and therefore being purchased by individuals) were the shares of highly innovative or risk-taking small Canadian corporations the point would be well-made. Asper, like Wilson, rests his claim for favourable treatment on this very point, in the belief that

[a] capital gains tax at full rates will have the unfortunate effect of redirecting the allocation of resources away from risk situations. Clearly, if the capital profit one makes by taking a risk and making a gain is to be taxed at the same rate as the capital profit made from a safe investment, one will opt for safety, except in situations where the profit potential is spectacular ...<sup>72</sup>

He concludes:

[On] balance ... a capital gains tax, particularly of the type envisioned by the *White Paper* [of 1969] would be a bad thing for Canada, and a disaster for the private enterprise economy...<sup>73</sup>

These comments assume that investors will be more likely to choose risky investments over safe investments if favourable treatment is given for capital gains taxation. This is not borne out by the evidence of the last few decades. Given the assured tax saving, people have been far more likely to invest in "safe" investments, primarily in real estate. This propensity was increased by the introduction of a \$500,000 capital gains exemption (witness the unprecedented rapid rise in sales of real estate in Toronto when the exemption was first introduced).

Concern has also been expressed that the capital gains exemption is not limited to specifically targeted investments that might, for example, result in job creation in Canada. Instead they are "wasteful and an unrec-

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71. See W. Stewart, *Towers of Gold, Feet of Clay: The Canadian Banks* (Toronto: Collins, 1982).

72. *Supra*, note 44 at 99

73. *Ibid.* at 101



essary concession to those who invest in items such as expensive jewelry, speculative land, foreign vacation properties, antiques, and deep discount bonds.”<sup>74</sup>

Even if the criteria for obtaining the exemption or preferential treatment had been directed more towards needed investments, it may not have been a complete answer to the critics. Evidence suggests that corporate investment is more sensitive to expected capacity utilization than to changes in rates of return resulting from changes in taxes on personal investment.<sup>75</sup> A report released by the U.S. Treasury Department regarding the economic impact of having lowered the individual capital gains tax rate in 1978 from about 49 to 28 per cent concluded “that such a drop in the capital gains tax rate would cause only a modest increase of about 1 per cent in economic growth, capital formation, productivity, and long-run consumption levels.”<sup>76</sup> These conclusions have some support from Canadian sources.<sup>77</sup> Furthermore, favourable taxation of capital gains encourages businesses to invest in capital rather than labour intensive industries, thereby retarding employment growth.

Ironically, the present system of capital gains taxation is more likely to discourage “risky” investments due to the treatment of capital losses. Only one half of losses are deductible. This will be increased to 66 2/3% in 1988 and 75% in 1989 with the introduction of further taxation<sup>78</sup> and only against capital gains (prior to the 1985 amendments, individuals were allowed to deduct up to \$2000 of allowable capital losses against other income). Obviously, such restricted loss treatment will militate against the risk-taker. By definition, “risky” investments have a greater chance of losing money than other types of investments. The extent to which losses can be offset will play major role in decisions regarding the type and extent of investments purchased. Any rational taxpayer faced with a guaranteed tax free profit of 50% if the investment proves a winner, but an accentuated loss if it does not, is more than likely “to play safe” and invest in a guaranteed, albeit relatively modest, winner. Unwittingly, the odds have been increased against the risk-taker. The potential risks of speculative investments have been raised to make them less, rather than more, palatable. Bossons gives an example of an investment that might be expected to yield

either a capital gain of \$50,000 or a capital loss on the same amount. The capital gain would result in tax of \$14,000 assuming a 56% marginal tax rate. By contrast, assuming a 12% discount rate, the capital loss would result in current and future tax reductions having a present value of only \$7,914. For an investment in these circumstances the effective tax rate on capital gains is almost double the effective rate applicable to capital losses. The investment disincentive created by this asymmetry in-

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74. Lawlor, *supra*, note 50 at 57.

75. See Bossons, *supra*, note 69 at 154.

76. Cited in Lawlor, *supra*, note 50 at 59.

77. Canada, *A Review of the Taxation of Capital Gains in Canada* (Ottawa: Department of Finance, 1980).

78. See *White Paper, 1987*, *supra*, note 3 at 34.

creases as the risk of capital loss rises, and so creates a tax-induced bias against risk-taking.<sup>79</sup>

Not everyone shares this view. A contrary opinion has been voiced by Thorsteinsson, who argues, without any empirical backing, that it is a fundamental conceptual error to state the case in this manner. The business person invests to make gains, not losses, and accordingly this is her main focus and concentration.<sup>80</sup> Neither position can be completely validated by the existing empirical data. What information there is suggests that taxation does not greatly bias the investment decisions of investors, although there is some evidence that the sharing of losses helps the conservative investor to take increased risks.<sup>81</sup> For example, Bossons' research found that high-income individuals were far more concerned with high marginal tax rates than whether particular investments were granted favourable treatment for taxation purposes. Not surprisingly, the effect differed according to the preferences of the individuals. For income-minded and security-minded individuals the preferential treatment given to capital gains was irrelevant, but for those taxpayers who wanted capital appreciation it was very important. For an investor in the latter circumstances, the effective tax rate on capital gains is almost double the effective rate applicable to capital losses. The investment disincentive created by this asymmetry increases as the risk of capital loss rises, and so creates a tax-induced bias against risk-taking.

What, then, should be done? Full taxation of capital gains and, conversely, full relief for capital losses is the answer. Critics complain such a system would result in enormous revenue losses. The government would, in effect, be forced to participate fully in any hair-brained scheme concocted by a taxpayer. This scenario is highly unlikely: the government will not lose money or become an unwilling investor in outlandish schemes any more than it does currently. The extra lost revenue will be made up to a considerable extent by the extra revenues gained from the increased taxes on gains. As well, the rules requiring that there be a reasonable expectation of profit before losses can be claimed will for the most part ensure that the schemes invested in have some chance of success. Further safeguards are not really required.

One flaw in a system of full deduction arises because the taxpayer is given the option of realizing the loss at any time. This may create inequity, allowing wide latitude to taxpayers in planning their affairs to decide when and what amount of taxes to pay. Yet the problem can easily be remedied. Unless the option is taken to realize gains and losses on a yearly basis,

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79. *Supra*, note 69 at 152.

80. P.N. Thorsteinsson, "Capital Gains" *Report of Proceedings of the Nineteenth Tax Conference Convened by the Canadian Tax Foundation* (Toronto: The Foundation, 1967) 357 at 359 and *Capital Gains and Canadian Tax Reform* (Don Mills: CCH Canadian, Ltd., 1971).

81. See Bossons, *supra*, note 69. See also: J.K. Butters, L. Thompson and L.L. Bollinger, *Effects of Taxation Investment By Individuals* (Cambridge, Mass.: Harvard University Press, 1965); A. Drache, "An Evaluation of the Criticisms of the Capital Gains Proposals of the Report of the Royal Commission on Taxation" (1969), 47 *Can. Bar Rev.* 583; Sinai, Lin, and Robins, "Taxes, Savings and Investment: Some Empirical Evidence," (1963), 36 *Nat'l Tax J.* 297.

losses may only be taken against capital gains which have been realized. The Carter Report did not consider such restrictions required nor appropriate and were prepared to allow unrestricted deduction of losses against all types of income up to two years carry back and forward forever. This seems unnecessary and overly favourable if taxpayers are able to choose when the tax liability arises.

## 2. Double Taxation

The taxation of capital gains has also been criticized as double taxation. The gains on ordinary shares are mainly derived from the reinvested and previously taxed profit of corporations. The incidence of corporate tax is still unclear but it is obvious that some of the corporate tax liability is passed onto consumers. Additionally, corporate taxes fall on both distributed and undistributed profits and the former are subject to personal income taxes. In view of the fact that there are many capital investments besides corporate shares, it is difficult to single out capital gains as deserving special treatment. Such concerns can be more specifically and appropriately dealt with by other measures: for example, dividend tax credits and the capital dividend provisions in the *Income Tax Act*.

## 3. Administrative Difficulties

Another concern often expressed centres on the tremendous administrative difficulties which would arise in the event of imposing taxes on capital gains. Reasons most usually cited concern the increased workload that would result for tax personnel in checking forms and verifying information. The transitional provisions would undoubtedly be complicated, causing considerable time and expense.

This is, without doubt, one of the most spurious claims put forward by the advocates of non-taxation of capital gains. Full taxation of capital gains would considerably lessen administrative difficulties both in terms of time and expense. The elimination of the capital/income division, one of the most contentious and certainly most litigated distinctions in the *Income Tax Act*, would result in enormous savings both administratively and judicially. Many complicated provisions now dealing with capital gains could be dispensed with because the tax consequences would be the same whether the transaction was regarded as a capital or an income one. There would necessarily be complicated transitional provisions, but attempting to provide equity to those favoured by the tax treatment for decades can hardly be used as a weapon against realizing future equity for all taxpayers. As Drache<sup>82</sup> so aptly points out, if one were to justify the non-taxation of millionaires on the grounds that the revenues were insignificant and the administrative difficulties large there would be an understandable outcry. Few, if any, would consider this a legitimate or appropriate ground on which to justify exemption from taxation. Why then should it be seriously considered within the context of capital gains?

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82. *Supra*, note 81 at 608.

#### 4. Foreign Investment

Concerns are sometimes expressed over the possibility that full taxation of capital gains will frighten away foreign investors. If capital gains are taxed at more favourable rates elsewhere (especially in America and England, Canada's major competitors), then Canada will lose much of the foreign investment upon which it relies so heavily. This point has lost much of its force with the recent elimination of preferential capital gains treatment in the latest of U.S. tax reform.

What evidence there is tends to suggest that Canada would not lose trade or investment as a result of taxation of capital gains, nor indeed would it be exceptionally damaging even if favourable treatment for capital income were reinstated south of the border.<sup>83</sup>

#### 5. Political Expediency

Finally, mention should be made of the most pressing, and possibly most unprincipled, objection to the taxation of capital gains: political expediency. It would be an extremely difficult task for any government to introduce increased taxation on capital gains unless considerable concessions were made elsewhere. The very people who make large amounts of income in the form of capital gains also tend to be the main contributors to political campaigns. Equity is not uppermost in their minds. This issue will not be addressed unless and until politicians are made to face unpleasant consequences. The issue must be dealt with in terms of equity and justice. Unfortunately, there is little prestige in doing so. Those who lose by the unfair treatment tend to be less well-organized politically. Accordingly, few political gains will be made by the government willing to take on this politically unpopular issue. Furthermore, those in power may have a hidden agenda: to ensure that accumulations of wealth remain intact and the division of income remains intact. If this is even a small part of the agenda, it has certainly been successful.<sup>84</sup>

### IV. The Advantages of the Full Taxation of Capital Gains

So far I have dealt with the disadvantages of taxing capital fully. In doing so, and particularly in refuting some of the arguments, some of the advantages have been implicit. It is time to look at some of those advantages more closely.<sup>85</sup>

#### A. Equitable Considerations

The most pressing and overwhelming argument in favour of the full taxation of capital gains concerns fairness, both substantive and formal.

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83. See Drache, *ibid.*, at 615 and G.R. Conway, *The Supply of, and Demand for, Canadian Equities* (Toronto: Toronto Stock Exchange, 1970) at 18.

84. See W. I. Gillespie, "On the Redistribution of Income in Canada" (1976), XXXIV Can. Tax J. 419.

85. For an excellent description of the advantages, see N. Brooks and A. Pettomoa, "The Case for Full Taxation of Capital Gains" (1979), 1 Can. Tax'n: J. Tax Pol'y 7.

The distortions caused by the present favourable treatment of capital gains can only be justified, if at all, on economic grounds, and even this argument is, at best, ambivalent. Certainly the inequities and distortions that are created are real and disturbing. To allow the preferential treatment to continue brings the taxation system into disrepute, flying in the face of the main aims and objectives of the tax system to which most people would subscribe.

What, then, are these objectives? There are five components of a "good" income tax system that most people would endorse as necessary requisites of a workable and fair taxation system: 1) ability-to-pay; 2) fairness; 3) neutrality; 4) integrity of the tax system, and; 5) administrative efficiency.<sup>86</sup>

The full taxation of capital gains would accentuate the attainment of the first three of these aims and perhaps even the fourth, although this is not entirely clear.

### 1. Ability-to-Pay

As the term implies, this principle requires that taxes should be levied according to a person's economic means. Accordingly, a wealthy woman is required to pay more into the social pot than her less fortunate neighbour. This reasoning is, of course, the main impetus behind progressive taxation, whereby a person's taxes increase proportionately with the amount earned. If the principle is a legitimate one, which is assumed, then all taxes should attempt to enhance it. Yet the present tax treatment of capital gains impedes its realization, undermining the few provisions of the *Income Tax Act* which attempt to further the principle of ability-to-pay. Indeed, it actually reduces the tax burden of the richer person. By taxing capital gains at effectively half the rate (or in 1989 at three-quarters of the rate) of other types of income, it considerably lowers the taxes of those who can realize a good portion of their income in capital gains. This effect is exacerbated by the fact that those who can afford to raise a large portion of their income in this fashion are overwhelmingly wealthier taxpayers. For example, in 1984 taxpayers with incomes over \$100,000 represented only 0.5% of all taxfilers and 10% of filers with taxable capital gains. However, they accounted for 34% of all capital gains. Those filers with incomes over \$50,000 accounted for approximately 60% of all capital gains.<sup>87</sup>

The current tax treatment of capital gains turns the ability-to-pay principle on its head. Furthermore, it solidifies and accentuates the increasing gap in the division of wealth in this country. Whether the *Income Tax Act* should actively seek to redistribute wealth in this country is a matter of debate (depending often on the present wealth of the advocate) and need not be debated in this paper nor in this context. Even though Canada pays lip service to the notion of redistribution, it has certainly not taken

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86. Endorsed by the Carter Commission, *supra*, note 42, vol. 1.

87. See Revenue Canada, *Taxation Statistics* (Ottawa: Minister of Supply and Services, 1986).

place.<sup>88</sup> But the Act should, if not lessen the disparities in wealth, at least ensure that they are not widened. Yet the lack of adequate taxes on capital gains does exactly this. Little can justify such disparities in the taxation of different types of income, especially when they so obviously work in favour of those who need preferential tax treatment least.

This latter consideration is not based on the proposition that Canada should have some form of wealth taxation. Although an extremely strong case can be made in favour of such taxation,<sup>89</sup> the question of whether Canada should introduce such a tax is irrelevant to the issue of capital gains taxation. Unfortunately, the two issues often become confused, perhaps deliberately so. For example, Bossons comments that capital gains taxation can be justified on the grounds that it is "one of the primary ways in which wealth is taxed; as such it is a major component of taxes on high-income individuals."<sup>90</sup>

Although true, the statement is misleading. The rationale for capital gains taxation need not rest on the idea that large accumulations of wealth are a danger to the fabric of society, both in terms of the unacceptable inequities that are created and of the threat which large concentrations of power pose to a democracy. The debate can be firmly based in the liberal arena of fair and equal treatment of individuals. Favourable treatment of capital gains is a tax expenditure made in favour of those who are able to raise a large proportion of their income in the form of capital. Taxation of wealth is not the issue in this context. All that is under consideration is whether one type of income, capital income, should be more favoured in the tax system than another, non-capital income. Given this, the burden of proof lies heavily upon those who advocate a deviation from the tax bases, an onus which has not been displaced.

## 2. Equity

Equity in the tax sense has two branches: horizontal and vertical. Horizontal equity requires that people in like positions be treated in the same manner whilst vertical equity requires that people in unlike positions be treated appropriately differently. The present treatment of capital gains offends both types of equity. People who have the same dollar incomes are not treated alike. Their tax bill may differ radically dependent upon the source of their income. For example, if two taxpayers, Ms. A and Ms. B, both have taxable incomes of \$40,000 in a given year, the taxation imposed will not be dictated by the amount of income, but by the source of that income. If Ms. A received her \$40,000 as a result of working as a junior executive and Ms. B. received her \$40,000 as a result of the sale of shares in that year the taxation would be considerably different. Indeed, assuming that Ms. B. has not used up more than \$60,000 of her lifetime capital gains ex-

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88. See Gillespie, *supra*, note 84.

89. For an excellent discussion of this issue, see R. Bird, "Taxing Personal Wealth: Selecting a Strategy" (1980), 2 *Can. Taxation: J. Tax Policy* 35.

90. *Supra*, note 76 at 145.

emption, she would pay no tax, whereas Ms. A would pay approximately \$13,000 (if she were an Ontario resident).

Vertical equity is also undermined. Again, because of the favourable treatment given to capital gains, someone who earns \$40,000 as a result of the sale of shares will pay less tax than a labourer who earns \$20,000. In a taxation system based on fairness as reflected in ability to pay, this type of differential is unacceptable.

### 3. Neutrality

An income tax system is expected, so far as possible, to ensure that there is impartiality in its provisions. This helps ensure equity and, moreover, aids economic efficiency. Economic efficiency requires that taxpayers be allowed to choose their own investments without tax-induced bias. Favourable treatment of capital gains deliberately distorts the market by encouraging taxpayers to place their money in capital assets in preference to other assets: for example, bonds or high yielding dividend shares.

This can result in unfortunate side effects. The most major one is the potential or actual misallocation of funds. Enticing taxpayers to invest in capital assets when they would not otherwise have done so means that funds are being taken out of – or, at least, not invested in—other types of activities. This will have unknown and, for the most part, immeasurable effects on the market. Good arguments must be made to justify the effects of such distortion. As it is impossible to anticipate in advance where the withdrawal of funds will arise and what the effect of such withdrawals will be, it can hardly be considered a thoughtful or economically efficient policy. Therefore, even economic factors point towards the full taxation of capital gains.

### 4. Integrity of the Tax System

One of the most remarkable characteristics regarding the Canadian tax system is its cost effectiveness; it costs approximately one cent for every dollar collected.<sup>91</sup> It is one of the most efficient tax collection systems in the western world. This is due in large part to the fact that it is a self-assessment system. In order to work, the system is reliant to a very large extent on the good will and honesty of individual taxpayers. To warrant this integrity, the taxation system must not only be fair, but must also be seen to be fair and unbiased in its treatment of all taxpayers. The present treatment of capital gains undermines this goal to a considerable extent, for statistics reveal that highly privileged individuals are the overwhelming beneficiaries of this preferential treatment. For example, in 1982 persons with incomes above \$50,000 represented only 18% of tax filers with net taxable gains, but they accounted for 63% of the value of taxable capital gains.<sup>92</sup> This trend has continued.<sup>93</sup> When these statistics are revealed, less

91. See Revenue Canada, *supra*, note 87. The costs imposed on collectors such as employers are not factored into this figure.

92. See National Council of Welfare, *Giving and Taking: The May 1985 Budget* (Ottawa: The Council, 1985).

favoured taxpayers become disillusioned. A low-income earner realizes that she is required to pay considerably more taxes, even though she may earn only a fraction of the non-taxpaying person's income. When disillusionment sets in, taxpayers become less willing to declare their income honestly and, moreover, enter the underground economy in increasing numbers.

The preferential treatment given to capital gains has played a large part in the increasing disillusionment with the tax system experienced by poorer and middle-income taxpayers. Certainly, it has contributed to the feeling that the rich are not paying their fair share of the taxes required by the government. In itself, this is cause for concern. Whilst most people do not enjoy paying taxes, most are willing to pay them to the extent that all are contributing according to their ability to pay. If people are to show honesty and integrity in filing their tax forms, the system under which they are taxed must show equal integrity. At a minimum, all taxpayers must be paying, and seen to be paying, a fair share of the tax burden.

### 5. Administrative Efficiency

Although administrative efficiency should never be an overriding concern, it is often an important consideration in tax matters. Would the introduction of capital gains taxation add to the complexity of the taxation system and therefore to the administrative burden and cost? Imposing this type of taxation would increase the complexity initially because of the complicated grandparenting provisions which would be required. Certainly, if the system outlined here were to be introduced it would entail a number of adjustments.

There would be a number of off-setting benefits. Of particular importance would be the abolition of the need for distinguishing between income and capital gains. This would save a great deal of administrative and court time.<sup>94</sup> Furthermore, there would be an increase in simplicity in the administration of the *Income Tax Act*. Other than the provisions relating to bunching and grandparenting provisions, the rest of the existing capital gains provisions could be repealed.

## V. Conclusion

The preferential tax treatment accorded capital income is unnecessary and unwarranted. Why, then, has it and does it continue to exist? There is some evidence to suggest that the division was made historically, at least in part, to entrench wealth and to keep the social divisions and its appurtenances, especially property, intact. Whether this remains one of

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93. Revenue Canada, *supra*, note 87.

94. For example, a casual counting of the Income Tax cases involving the capital gains/income distinction suggests that they accounted for 19% of all tax cases in 1979, 14% in 1982, 11% in 1983 and 1984 and 16% in 1986. Note these only refer to reported cases. If unreported cases were included, the numbers would be even more substantial.



the driving forces behind its continued preferential treatment is unclear and, unfortunately, unverifiable. Even so, tentative but significant inferences may be drawn from the evidence—inferences which certainly warrant further research and investigation. The various justifications put forward for preferential treatment for capital appreciation may be mere subterfuge. The underlying motives today may be the same as those present at the time of the introduction of the spurious division between capital and income: to perpetuate the division of wealth in society, to protect vested interests and to maintain existing social divisions.

This tentative hypothesis is raised for a number of reasons. First, the reasons most often cited for preferential treatment for capital income—equity and efficiency—have been shown for the most part to be at best, empirically unverified and, at worst, fallacious. Given that this favourable treatment flies in the face of the avowed goals and principles of an equitable tax system, it is hard to understand why it exists. Furthermore, and most curious, it favours predominantly the most wealthy and least needy of taxpayers, for no empirically justifiable reason. Unless the tax treatment of capital gains is part of a more general bias in the income tax system in favour of the wealthy encouraging large accumulation of wealth and capital assets (despite, or perhaps because of, progressivity), it makes little sense. If this has been, even subconsciously, part of the design for preferential treatment of capital income, it has undoubtedly been successful. Whether it would be an acceptable goal, if articulated, is unlikely. Perhaps the time has come to articulate and empirically identify the reasons for the continued preferential treatment of capital gains and to finally march confidently into an era of true and fair tax reform by abolishing, once and for all, this anachronistic and unjustifiable preference in favour of capital assets.