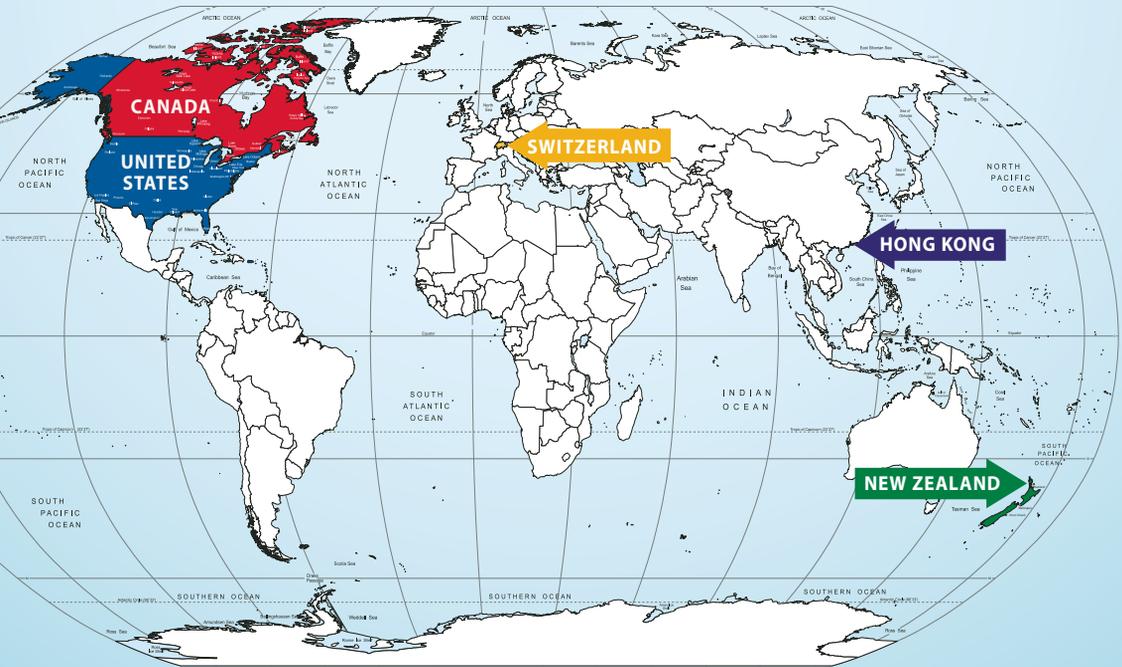


CAPITAL GAINS TAX REFORM IN CANADA

LESSONS FROM ABROAD



Edited by Charles Lamnam
and Jason Clemens

Foreword by Herbert Grubel

November 2014

Capital Gains Tax Reform in Canada: Lessons from Abroad

Edited by Charles Lammam and Jason Clemens

with a foreword by Herbert G. Grubel

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Foreword

Herbert Grubel, PhD

After a protracted period of deficit spending and debt accumulation, in the fall of 2014 the federal government is expected to develop significant fiscal surpluses in the near future. This forecast has led to considerable debate about how best to use them.

In the late 1990s, the federal government faced similar decisions with respect to newfound fiscal room. The Fraser Institute contributed to that debate by hosting, in 1997, a conference at which economists discussed priorities for the use of expected future budgetary surpluses. One of the most important conclusions reached by the conference participants was that the government should use the surplus to lower personal income taxes to make the Canadian system more competitive with that of the United States and other industrialized countries (Grubel, 1998).

This conference was followed in June 1999 by a symposium at which economists focused on possible reforms to Canada's capital gains tax regime. The symposium's discussion was summarized in a volume published by the Fraser Institute (Grubel, 2000). The consensus view was that Canada's capital gains tax rates should be eliminated or lowered.

This conclusion is likely to have influenced the federal government's range of tax reductions in the year 2000, which included a reduction in the effective rate of capital gains taxation that was achieved by lowering the rate at which realized capital gains were subjected to taxation from 75 percent to 50 percent. The reform also allowed a tax-free rollover for capital gains on qualified investments from one small business to another, and postponed the taxation of gains on qualifying company shares.

Now, nearly fifteen years later, the country finds itself in a similar situation. The federal government, after posting budgetary deficits for seven

years, has projected a balanced budget in 2015 and substantial surpluses thereafter. In the expectation of these surpluses it has signaled that its top, post-deficit priority is “examining ways to provide further tax relief for Canadians” (Canada, Department of Finance, 2014: 192).

To assist with this examination, the Fraser Institute has commissioned a number of authors to present their views on the merit of providing capital gains tax relief as one of the most beneficial forms of tax relief available to the government. This recommendation flows from the simple fact that Canada’s capital gains tax rate has remained unchanged since 2000 and is now the fourteenth highest among the 34 countries that were members of the Organisation of Economic Co-operation and Development in 2013.

The reason for recommending the reform of the capital gains tax regime is that capital gain taxes carry considerable economic costs and produce relatively little revenue. Empirical research shows that capital gains taxes impose high costs on the economy by reducing the supply of capital. They also lower the levels of entrepreneurship and risk taking, and distort the efficient allocation of new investments.

The revenues from capital gains taxes were estimated to have been only \$2.8 billion in 2011. It may be expected to have grown by only a small amount thereafter. Therefore, the loss of revenue that would result from a reduction in capital gains taxes is small relative to projected federal surpluses of \$6.4 billion in 2015–16 and over \$10 billion in 2018–19. In fact, it is not unreasonable to expect that a reduction in the rate of capital gains taxation will increase revenues. This proposition follows from the study by Simonova and Lefebvre (2008), which shows that the proportion of Canadians reporting capital gains increased by 12.5 percent between 1999 and 2000 and continued to grow thereafter.

The essays in this volume support the case for the reform and even elimination of the capital gains tax as priorities in the government’s tax relief program. They do so by examining the experiences of other jurisdictions that operate with zero rates of capital gains taxation or that use different methods to apply the tax.

An effort by the Fraser Institute to inform the debate over taxation in the 1990s was very successful. It is my hope that the essays in this volume will similarly influence the current debate and lead to capital gains tax reforms and relief that will once again stimulate economic growth and increase the well-being of all Canadians, as it did following the reforms in the year 2000.

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About the author

Herbert Grubel

Herbert G. Grubel is a Fraser Institute Senior Fellow and Emeritus Professor of Economics from Simon Fraser University in British Columbia. He has a BA from Rutgers University and a PhD in Economics from Yale University. He has published 16 books and 180 professional articles in economics dealing with international trade and finance and a wide range of economic policy issues.

Introduction

Charles Lammam and Jason Clemens

With the federal government poised to eliminate the budgetary deficit in the coming year, a debate has commenced about how best to direct future budget surpluses. Some voices have called for tax relief while others have emphasized new spending.

The backdrop to these fiscal policy discussions is a sluggish economy. The consensus view of most economists is that the Canadian economy will continue to struggle with lower than “normal” or historic levels of economic growth. Low economic growth has broad implications including slower growth in employment, income, and ultimately living standards. This means any debate about using future budgetary surpluses should focus on policy measures that can improve economic growth in both the short and the long term.

One area of policy reform that could contribute to higher levels of economic activity is capital gains taxation. A wealth of research shows that capital gains tax reform can increase the supply and lower the cost of capital available to new and expanding firms, and in turn lead to higher levels of entrepreneurship, economic growth, and job creation.

The primary reason that capital gains tax reform can have these positive effects is related to what economists call the “lock-in effect.” Because capital gains are only taxed upon realization, high tax rates on capital gains can create an incentive for investors and asset holders to retain their current investments even if more profitable and productive opportunities are available. The magnitude of the lock-in effect depends on a number of factors, but a series of empirical studies has found a negative relationship between capital gains tax rates, asset sales, share prices, and other proxies for investor activity. This leads to inefficient capital allocation, delays in investor redeployment of

capital, and distortions in the capital markets, all of which hinder economic growth by limiting the capital that businesses can access.

The economic case for capital gains tax reform, then, is rooted in large part in the relationship between taxation and capital supply for new and expanding businesses. Capital gains tax reform could reduce the lock-in effect and the deleterious consequences that stem from it.

Why capital gains tax reform?

Such a reform would come at an important juncture as governments continue to grapple with how to address a perceived lack of access to capital for new and expanding businesses. Canadian governments have experimented with a range of policies, including the creation of provincial funds-of-funds, direct investments into existing private sector funds, and the introduction of tax credits for venture capital investments, to address the problem. Yet it seems to persist and is potentially contributing to low levels of new firm creation in Canada.

In light of this policy preoccupation with new-firm financing, it is odd that the tax treatment of capital gains has been largely absent from the policy debate. This is especially peculiar given the success of the two capital gains tax reductions in the early 2000s by the then governing Liberal Party, and since the current government committed to the concept of a capital gains rollover during the 2006 federal election campaign and has yet to follow through on it.¹

The federal capital gains tax inclusion rate has gone unchanged in nearly 15 years.² Canada's highest personal capital gains tax rate is now the fourteenth highest among the 34 countries comprising the Organisation of

1 The party's platform stated: "[if elected the Conservative Party would] eliminate the capital gains tax for individuals on the sale of assets when the proceeds are reinvested within six months. Canadians who invest, or inherit cottages or family heirlooms, should be able to sell those assets and plough their profits back into the economy without taking a tax hit. It is time government rewarded Canadians who reinvest their money and create jobs" (Conservative Party of Canada, 2006).

2 The federal government has increased the lifetime capital gains exemption for qualifying private company shares (including farm and fishing property) from \$500,000 to \$800,000 and indexed it to inflation starting in 2015 (Department of Finance, 2013).

Economic Co-operation and Development (OECD) in 2013. In fact, 11 OECD countries currently impose no capital gains taxes.

At a time when Canadian governments are searching for policy options to improve access to capital for new and expanding firms it would be wise to consider reforming the tax treatment of capital gains. Eliminating capital gains taxes or reforming the application of the tax through a rollover mechanism could help to increase Canada's supply of early-stage financing and in so doing contribute to greater levels of entrepreneurship, higher economic growth, and more job creation.

Lessons from abroad

The experiences of other jurisdictions that have experimented with a zero capital gains tax or reforming how the tax is applied are a lesson in this regard. Hong Kong, New Zealand, Switzerland, and the United States have adopted different tax policies with respect to capital gains and experienced different economic outcomes.

Hong Kong, New Zealand, and Switzerland: Zero capital gains tax rates

Hong Kong, New Zealand, and Switzerland currently impose no comprehensive capital gains taxes. There are slight differences between each of the jurisdictions with respect to the treatment of different types of assets (for instance, some Swiss cantons impose special taxes on capital gains realized on immovable business property) but overall all three of them have deliberately chosen a zero-rated capital gains tax rate as their general policy.

Indicative of the recognition of the importance and benefits of a zero capital gains tax rate is the fact that governments in all of these countries have consistently resisted political calls to raise capital gains taxes due to the empirical evidence that these taxes have a negative effect on capital formation and discourage entrepreneurship. Indeed, as Australian economist Stephen Kirchner writes about New Zealand's experience: "the lack of a comprehensive CGT [capital gains tax] is not an oversight but a deliberate policy choice."

The choice to maintain zero-rated capital gains taxes is motivated in part by the research on the optimal structure of taxes and the marginal

efficiency research with respect to capital gains taxes relative to other forms of taxation. But the issue of economic and tax competitiveness also looms large in the essays. There are discussions in the Hong Kong, New Zealand, and Swiss essays, for instance, about the challenges of small, open economies and the discipline that imposes with respect to general economic and tax policies.

As economist Bill Stacey sets out in his essay about Hong Kong's capital gains tax regime, the jurisdiction's zero capital gains tax rate has been a key part of its efforts to build itself as a financial centre and a location for regional corporate headquarters.

Christoph Schaltegger and Marc Winistoerfer also discuss the issue of capital mobility and the extent to which the introduction of a comprehensive capital gains tax in Switzerland could encourage capital flight and hurt the country's economy. As the two economists put it: "Capital gains are not part of inelastic tax bases, hence the adoption of general capital gains taxation would probably yield more economic distortions rather than fewer."

The key finding from these essays is that successive governments in Hong Kong, New Zealand, and Switzerland have maintained zero capital gains taxes because of the compelling evidence that such taxes are inefficient relative to other forms of taxation and on balance would hurt their respective economies.

United States: Differential capital gains tax rates and rollover provisions

The United States's capital gains tax regime is more complicated. Short-term capital gains on the sale of assets held for a year or less are treated as ordinary income. Gains on the sale of assets held for more than one year are considered long-term capital gains. Long-term capital gains are taxed at a preferential lower tax rate: zero percent if the taxpayer is otherwise in the 10 percent or 15 percent marginal tax rate, 15 percent for other taxpayers with taxable incomes up to \$400,000 (single filers), \$450,000 (married filing jointly), and \$425,000 (single head of household), and 20 percent for higher-income earners.³

3 The top income threshold for the 15 percent bracket in 2014 is \$36,900 for single filers, \$73,800 for joint filers, and \$49,400 for heads of households. That part of capital gains or qualified dividends that would fall into the 10 percent or 15 percent brackets if other income did not exhaust those brackets gets the zero tax rate.

The United States has also experimented in the past with rollover provisions whereby any capital gains stemming from the sale of one's primary residence could be reinvested into another residence without incurring taxation. This policy has since been replaced with a special exclusion from capital gains tax (\$250,000 for single filers and \$500,000 for married filers) on gains on a principal residence in which the seller has lived for at least two of the last five years prior to the sale. Government policy also continues to allow for rollovers and consolidation within Individual Retirement Accounts without triggering taxation. This experience with rollover provisions for certain assets or within specific investment vehicles provides some evidence of their possible utility and implementation options.

Stephen Entin's essay on the US capital gains tax regime also provides credible evidence that the economic benefits of low capital gains taxes outweigh the potential costs. Historical changes in the capital gains tax rates have been closely associated with changes in investor behaviour. Herein lies a lesson for Canadian policy makers.

Indeed, the recent American experience shows that investors respond to capital gains tax changes. As Entin shows, an increase in the top capital gains rate announced in 1986 and enacted in 1987 led to a near doubling of capital gains realizations in anticipation of the pending tax increase. The 2012 American Taxpayer Relief Act increased the top rate on long-term capital gains with advanced notice, and Entin's essay shows that this will have likely contributed to a surge in capital gains realizations in 2012 to avoid the rate increase but a dip in realizations in 2013 as the new rate is imposed.

Entin's analysis is consistent, of course, with a broader literature on the tax sensitivity of investors and the need for policymakers to understand the extent to which changes in the capital gains tax rates can influence investment activity. The policy implication from the US experience, therefore, is that capital gains tax reform could provide a boost to the Canadian economy.

Overall, the lessons from these other countries point one in the direction of capital gains tax reform. The potential boost in investor activity could help to address the perceived capital supply issue in Canada and contribute to higher levels of entrepreneurship and economic growth.

Risk of “income-shifting”

A common objection to capital gains tax reform (particularly the elimination of capital gains taxes) is that an incentive would be created for taxpayers to shift taxable income into non-taxable capital gains, a practice often referred to as “income shifting” or “surplus stripping.” That is, if there were no capital gains taxes, business owners would attempt to reduce the amount their businesses distribute as dividends and instead reinvest money in the business. The owners could then undertake legal manoeuvres to “strip” the reinvested funds as tax-free capital gains. In addition, an incentive would also be created for professionals and others who operate through a wholly-owned corporation to shift ordinary taxable income, normally paid as salary, into non-taxable capital gains.⁴

Grubel (2001) reviewed the international evidence on the effects of having no capital gains taxes and concluded that income shifting would be limited by two factors: (1) methods for income shifting are complicated and costly for small and wholly owned businesses, and (2) publicly traded companies face strict accounting rules and market discipline that make it difficult to engage in such activities.⁵

The issue of tax avoidance is addressed in each of the international essays in this collection. The authors acknowledge that the potential for avoidance is a policy issue that these governments have grappled with but that the risk can be managed and in any case does not outweigh the benefits of maintaining a zero-rated capital gains tax.

For instance, Kirchner recognizes that New Zealand’s capital gains tax regime can create anomalies, complexity, and even the potential for avoidance, but makes the case that these can be addressed through ongoing vigilance and policy reforms if and when necessary.

Schaltegger and Winistoerfer observe that concerns about tax avoidance have been part of the policy debate in Switzerland, but that the solution

4 See pages 16–19 in Grubel (2001) for two theoretical examples of “surplus stripping.”

5 Numerous participants at a 1999 Fraser Institute symposium on capital gains taxes had worked in the financial sector during the 1960s, when Canada had no capital gains taxes, and indicated that surplus stripping was not a major problem at that time (Grubel, 2003).

has been to address issues through targeted “legal adjustments” as they arise, rather than through the introduction of a capital gains tax. This approach has been largely successful in combatting any tax avoidance issues that emerge.

Hong Kong has introduced a series of legal and institutional policies to address the risk of tax avoidance. Stacey explains, for instance, that the fact that Hong Kong also does not tax dividends or interest income limits the incentives to shift income. Past research on the Hong Kong experience finds that the government has established a Board of Review to hear appeals of disputes with the tax authorities (Hsu and Yuen, 2001).

These experiences show that, while concerns about income shifting and tax avoidance are not without any basis, there is sufficient scope for governments to enact anti-avoidance measures and to protect against revenue leakage.

Equity considerations

Another common objection to capital gains tax reform is the perception that only a small number of high-income earners realize capital gains and therefore will stand to benefit. Government data on taxable capital gains are often cited as evidence of the unequal distribution. But, as the first essay explains, these concerns are overstated and partly the result of problems with relying on tax data to evaluate the income distribution of capital gains.

The first issue is that a considerable percentage of Canadians receive capital gains in Tax-Free Savings Accounts, Registered Retirement Savings Plans, Registered Pension Plans, and in their primary residences, but these capital gains are either non-taxable or treated as ordinary income and therefore are not reflected in the tax data as capital gains. The point is that government policy already exempts a large share of taxpayers from taxation⁶ in the name of encouraging investment, savings, and homeownership, and tax data provides an incomplete picture of the distribution of capital gains.

6 As an example, recent Department of Finance estimates suggest that approximately 8.2 million Canadians hold Tax-Free Savings Account (TFSA) with a total value of \$62 billion in assets, and the distribution among income groups finds that more than 25 percent of the total value in TFSA contributions was made by individuals with incomes between \$20,000 and \$40,000, and more than 20 percent was made by individuals earning less than \$20,000.

The second problem with relying on tax data is that it includes taxable capital gains income in people's annual income, which inflates an individual's annual income due to one-time asset sales and thus contributes to the concentration of taxable capital gains among high-income earners. This method of presenting the income distribution of taxable capital gains pushes those with large one-time capital gains—such as a small-business owner who sells his or her business in order to retire—into higher income groups. Put simply, the lumpy nature of asset dispositions results in statistics on the income of those with taxable capital gains that tend to overstate their wealth. A more appropriate measure of the distribution of taxable capital gains would be pre-taxable capital gains income.

In sum, concerns about the income distribution of capital gains ignores the fact that a significant number of Canadians across income scales realize capital gains even if these are not reflected in the tax data, and that the concentration of taxable capital gains is partly skewed by the inclusion of one-time assets sales in annual income. Any debate about the equity of capital gains taxes therefore needs to account for this reality. Tax policy can sometimes involve important trade-offs between the principles of equity and economic efficiency, and any debate about capital gains tax reform should not overstate the potential equity concerns.

Policy options for capital gains tax reform

In light of the economic evidence showing the deleterious effects of capital gains taxes and the positive experiences of these other jurisdictions, the case for capital gains tax reform is strong. Reform could take different forms.

1. Eliminate the capital gains tax

Capital gains taxes impose high costs on the economy and represent a small share of federal tax revenues. Eliminating the capital gains tax could provide a considerable boost to the Canadian economy at a small fiscal cost. It would unlock capital for new and expanding firms, bolster entrepreneurship, and support investment and job creation. This would be a productive use of future budgetary surpluses that would help to improve Canada's economic competitiveness at a time when moderate economic growth is expected for the foreseeable future.

Common objections to eliminating capital gains taxes tend to focus on equity concerns and the potential for tax avoidance or “income shifting.” This collection of essays has sought to address both of these issues directly.

As described in the first essay, concerns about the equity impact of eliminating capital gains taxes are overstated. Capital gains are already shielded from taxation for most Canadians, and tax data (a common source of income distribution analysis) tends to overstate the distribution of capital gains income.

As for the risk of tax avoidance, the international essays show that this is a concern that governments can address by regularly monitoring the system, introducing specific anti-avoidance measures as necessary, and keeping the general tax burden low. As Kirchner explains:

The New Zealand approach has been to close potential loopholes on an ad hoc basis if and when they pose a threat to revenue. Tax avoidance schemes are typically the result of high marginal tax rates that make such schemes profitable. Low tax rates are the best way to render such schemes uneconomic.

The main point, then, is that the economic benefits that would stem from eliminating the capital gains tax outweigh the drawbacks such as reduced government revenue and concerns about tax equity or the potential for tax avoidance.

2. Lower the capital gains tax rate

As has been discussed, economic research shows that capital is highly mobile and high capital taxes can discourage capital investment. This is one of the primary reasons that, as small, open economies, Hong Kong, New Zealand, and Switzerland have eschewed capital gains taxes.

Herein lies an important lesson for Canada. As a small, open economy competing for capital, Canada must ensure that its tax regime makes it an attractive investment destination. There has been progress in this regard with respect to corporate income taxes but, as the first essay in this collection shows, there is room for improvement on capital gains taxes.

Canadians currently face the fourteenth highest capital gains tax rate among the 34 countries comprising the Organisation for Economic

Co-operation and Development (OECD). Eleven of those countries do not levy personal capital gains taxes.

If the government did not wish to eliminate the capital gains tax rate, a second option would be to lower the inclusion rate from 50 percent to 25 percent. Doing so would improve Canada's tax competitiveness relative to other OECD countries and bolster its attractiveness as an investment destination.

This represents a real opportunity for Canada because, as Stephen Entin's essay describes, the United States raised its top tax rate on long-term capital gains from 15 percent to 20 percent in 2013. Lowering Canada's top tax rate on capital gains relative to the United States could bolster our attractiveness (similar to Canada's position vis-à-vis corporate income taxes) and draw new investment into the country.

3. Capital gains rollover

A third option would be for the government to enact its 2006 commitment to introduce a rollover mechanism for capital gains investment.

This would effectively keep the basic parameters of the capital gains tax regime in place but allow for a deferral of capital gains taxes for individuals on the sale of assets when the proceeds are reinvested within a certain time-frame, perhaps six months. The purpose of such a policy would be to mitigate the lock-in effect and encourage investors to shift capital from less productive investments to new, more productive opportunities. In effect, this policy would not eliminate or change the capital gains tax rate but rather defer the tax if the accumulated proceeds are reinvested in eligible assets in the name of encouraging capital activity.

The government's inaction on its promise to introduce some type of rollover for capital gains has been mostly attributed to perceived technical issues.⁷ Any implementation concern should be manageable, especially since we can draw from international experiences such as in the United States and the United Kingdom.

A rollover mechanism could be enacted in different ways. One of the more compelling proposals is set out by Mintz and Wilson (2006) and involves the creation of Capital Gains Deferral Accounts (CGDAs), which would allow

7 The former finance minister called it "difficult and complicated" to implement. See Chase (2008).

individuals to rollover investments within the account without having to pay capital gains until assets are fully withdrawn. Their proposal involves differentiated rates that would apply as the assets are withdrawn and a lifetime limit on the amounts to which investors can contribute to their CGDAs.

The specific details of their plan could be flexible and there would be room for the government to impose a different rate structure or investment limits than those set out in the proposal. But a key feature of the CGDA model is the ability to track investments and assets sales for the purpose of implementing a rollover mechanism. This model could go a long way towards addressing legitimate concerns about the complexity of introducing a capital gains rollover and the need for significant bureaucratic oversight and enforcement. The CGDA model could produce the upside of mitigating the lock-in effect, encouraging capital reallocation, with minimal downside of tax complexity and high administration costs.

Conclusion

The federal government's transition from a budgetary deficit to projected fiscal surpluses represents an opportunity to lay the foundation for long-term economic growth, particularly at a time of sluggish economic growth and ongoing concerns about a perceived lack of capital financing for new and expanding firms.

As Dr. Grubel notes, the government has signaled that its top, post-deficit priority is "examining ways to provide tax relief for Canadians" (Canada, Department of Finance, 2014: 195). Capital gains tax reform would represent a low-cost, high-impact measure that the government ought to consider as it plans for the 2015 budget.

The economic literature and the experience of other jurisdictions demonstrate the economic benefits that could stem from capital gains tax reform and provide a way forward with respect to possible implementation issues such as the risk of income shifting.

As discussed in the overview chapter and the subsequent ones on New Zealand, Hong Kong, Switzerland, and the United States, we have something to learn on how to capital gains tax reform can spur investment, entrepreneurship, and economic growth.

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The Economic Costs of Capital Gains Taxes in Canada

Jason Clemens, Charles Lamman, and Matthew Lo

This collected series of essays is dedicated to explaining the many benefits available to Canadians from further reducing the taxation of capital gains. This first essay is meant to provide readers with a general understanding of capital gains taxes, the economic costs imposed by extracting taxes from capital gains, and some basic information about capital gains taxes in Canada and other industrialized countries. Simply put: this essay aims to establish a foundation from which to review the options available for further capital gains tax relief, which are detailed in a comparative sense in the following four essays.

The economics of capital gains taxes: A literature review

A capital gain (or loss) generally refers to the price of an asset when it is sold compared to its original purchase price. A capital gain occurs if the value of the asset at the time of sale is greater than the initial purchase price. A capital loss occurs if the value of the asset at the time of sale is less than the purchase price.

Capital gains taxes, of course, raise revenues for government but they do so with considerable economic costs. Capital gains taxes impose costs on the economy because they reduce returns on investment and thereby distort decision making by individuals and businesses. This can have a substantial impact on the reallocation of capital, the available stock of capital, and the level of entrepreneurship.

Veldhuis, Godin, and Clemens (2007) carried out an extensive literature review on the economic costs of capital gains taxes with a particular focus on the effect on the reallocation of capital, the stock of capital, entrepreneurship and risk-taking, compliance costs, administrative costs and tax avoidance, and the marginal efficiency cost. This analysis draws heavily on their work and incorporates new empirical and theoretical research on these subjects.

Lock-in effect

Capital gains are taxed on a realization basis. This means that the tax is only imposed when an investor opts to withdraw his or her investment from the market and realize the capital gain. One of the most significant economic effects is the incentive this creates for owners of capital to retain their current investments even if more profitable and productive opportunities are available. Economists refer to this result as the “lock-in” effect. Capital that is locked into suboptimal investments and not reallocated to more profitable opportunities hinders economic output. Consider an investor who wishes to divest an asset and reinvest the proceedings in a new project. The profit received from the sale of the asset is reduced by the capital gains tax. In order for the investor to reallocate his or her capital, the new investment must provide a rate of return high enough to recoup the funds paid in taxes plus yield a reasonable rate of return.

While the magnitude of the lock-in effect depends on numerous factors (such as the rate of return on the initial and new investments and the investor’s time horizon), economic costs result because capital gains taxes discourage the reallocation of capital from lower to higher yielding uses. That is, capital gains taxes cause the economy to lose the extra output that the reallocation of capital would have produced. The lock-in of capital prevents the development of some new, potentially profitable, businesses that are engines of productivity, employment, and wealth creation.

Numerous academic studies have investigated the lock-in effect.¹ An influential paper by Harvard economist Martin Feldstein and his colleagues

1 Many studies provide empirical evidence of the lock-in effect. For instance, Jog (1995) finds evidence of a lock-in effect in Canada by examining the change in capital gains realizations after the 1985 introduction of a capital gains exemption. See also Landsman and Shackelford (1995), Shackelford (2000), Blouin et al. (2000), and Dai et al. (2006), for empirical evidence of the lock-in effect.

Joel Slemrod and Shlomo Yitzhaki (1980) was one of the first to provide an empirical analysis of the effect of taxation on the realization of capital gains, using the sale of corporate stocks at a profit as their test. The authors found that the realizing of capital gains is sensitive to the marginal tax rate. Their research concluded that a 10.0 percentage point increase in the capital gains tax rate reduced the probability of selling a stock by 6.5 percentage points.

Paul Bolster, Lawrence Lindsey, and Andrew Mitrusi (1989) evaluated the impact of the US government's elimination of the lower, long-term tax rate on capital gains in 1986 on stock market activity. The authors examined trading volume on the New York Stock Exchange and the American Stock and Options Exchange from 1976 to 1987. They found that trading volume significantly increased in the months leading up to the tax change and that trade volume significantly declined after the change was implemented: trading volume was 15.0 percent lower in January 1987 compared to the same month in previous years. The empirical results suggest that the expected increase in the capital gains tax rate induced investors to reallocate capital prior to the change in order to avoid higher taxes.

Peter Kugler and Carlos Lenz (2001) examined the impact of the lock-in effect on the overall economy by studying the effect of capital gains taxes in different jurisdictions with otherwise similar economic conditions and tax systems. The authors examined the experience of regional governments ("cantons") in Switzerland that eliminated their capital gains taxes. The authors' statistical analysis showed that the elimination of capital gains taxes had a positive and economically significant effect on the long-term level of real income in seven of the eight cantons studied. Specifically, the increase in the long-term level of real income ranged between 1.1 percent and 3.0 percent, meaning that the size of the economy was 1 percent to 3 percent larger due to the elimination of capital gains taxes.

Zhonglan Dai, Edward Maydew, Douglas Shackelford and Harold H. Zhang (2006) analysed the impact on asset prices from a reduction in the long-term capital gains tax rate with a particular focus on the lock-in effect and the impact on equity trading volumes. The authors used the capital gains tax cut set out in the US government's 1997 Taxpayer Relief Act to test the relationship between a tax reduction and asset prices and market activity. The analysis finds that equity prices were, on average, 8 percent higher than the normal weekly returns in the week leading up to the tax reduction, and

subsequently 1 to 2 percent lower following the tax cut, indicating that capital gains taxes have a significant effect on stock price movements.

James Chyz and Oliver Li (2012) also examined the lock-in effect with relation to the 1997 Taxpayer Relief Act, but with a specific focus on the extent to which a change in the capital gains tax rate affects investors' short-term incentives to sell shares with embedded gains as well as their long-term portfolio allocation decisions. Using a database containing holdings information of approximately 1400 institutional investors, the authors find that tax-sensitive² investors reduced holdings of shares with embedded gains after the tax cut was enacted. Taken together with Dai et al. (2006), these findings show that capital gains taxes not only affect the stock price, but also trading volumes.

Benjamin Ayers, Craig Lefanowicz, and John Robinson (2007) conducted a study on how capital gains taxes affect corporate acquisition activities³ using a set of panel data on corporate acquisitions from 1973 to 2001.⁴ After conducting aggregate level and industry level analyses, the study finds that, on average, a 5 percentage point decrease in the capital gains tax rate will increase the annual number of acquisitions by approximately 50 acquisitions—an increase in acquired value of \$26.5 billion. This is important because it shows that not only do capital gains taxes affect asset prices and market activity, they also influence corporate acquisition activity and the movement of capital across different organizations.

The “user cost of capital” and the stock of capital

Capital gains taxes have a significant impact on the stock of capital in Canada by increasing the cost of capital to Canadian businesses. By triggering market responses such as the lock-in effect, capital gains taxes make the gathering of capital more difficult, and create more obstacles for investment activities. Capital gains taxes make capital investments more expensive and therefore

2 Tax-sensitive institutional investors include mutual funds and their managers and investment advisors. Less tax-sensitive institutional investors included tax-exempt institutions such as pension funds, university endowments, and foundations, as well as insurance companies which are less likely to exhibit trading behaviour that is influenced by changes in individual tax rates.

3 Corporate acquisition activity is defined as the percentage of traded firms acquired in a calendar year.

4 The sample consists of firms traded on the New York Stock Exchange, the American Stock Exchange, and the NASDAQ over this period.

less investment occurs. Less capital has a number of negative consequences including decreasing the productivity of Canadian workers and ultimately lowering Canadian living standards.

Several studies have investigated the link between the supply and cost of venture capital financing and capital gains taxation, and found theoretical and empirical evidence suggesting a direct causality between a lower tax rate and a greater supply of venture capital.⁵

The extent to which capital gains taxes reduce the stock of capital depends on how sensitive businesses are to the cost of capital. That is, the critical question is at which point firms change their capital investment in response to changes in the cost of capital. Robert Chirinko and Andrew Meyer (1997) quantify the sensitivity of investment spending on the user cost of capital and estimate a 1 percent increase in the user cost of capital resulting from an increase in business taxes. Kevin Milligan, Jack Mintz, and Thomas Wilson (1999) sought to estimate the sensitivity of investment to changes in the user cost of capital in Canada and found that decreasing capital gains taxes by 4.0 percentage points leads to a 1.0 to 2.0 percent increase in investment.

Guenther and Willenborg (1999) examined the effects of a reduced capital gains tax rate on initial public offerings of qualified small business stock. In particular, the authors studied the effect of the US government's 1993 decision to reduce the capital gains tax rate on small business (defined as having assets of less than \$50 million) stock purchased from the corporation by individuals, and found that the policy increased the price that small businesses were able to charge for their stock. This is consistent with past research finding that capital gains tax rate reductions lower the cost of capital for such businesses.

Huizinga, Voget, and Wagner (2012) conducted an empirical study to measure the impact of capital gains taxes on the cost of capital in the context of international corporate mergers and acquisitions (M&As). Using a dataset of 5,349 M&As in OECD countries from 1985 to 2007, the analysts find that the effective tax rate on capital gains reflected in takeover prices (after accounting for deductions of realized losses on other shares) is 7 percent, and

5 See Poterba (1989a, 1989b); Gompers and Lerner (1998), Jeng and Wells (2000), Keuschnigg (2003, 2004), Keuschnigg and Nielsen (2001, 2003a, 2003b, 2004a, 2004b, 2004c), and Armour and Cumming (2006).

that it raises the cost of capital by 5.3 percent. This indicates that capital gains taxation is a significant cost to firms when issuing new equity.

Entrepreneurship and risk-taking

Entrepreneurs risk their own capital (and that of venture capitalists and other financiers) and time in the hopes of ultimately profiting from an unproven technology, product, or service. The trade-off is that they expect to be compensated if the business matures and generates financial returns. This process is key to a successful economy because it produces new technologies, products, and services, and ultimately leads to job creation and increased wealth.

Capital gains taxes reduce the return that entrepreneurs and investors receive from the sale of a business. This diminishes the reward for entrepreneurial risk-taking and reduces the number of entrepreneurs and the investors that support them. The result is lower levels of economic growth and job creation.

Capital gains taxes also affect an entrepreneur's ability to attract managers from traditional business sectors. Start-up firms cannot typically offer salaries that are competitive with established businesses and therefore often recruit managers using equity stakes. Capital gains taxes reduce the returns that these managers receive, thereby diminishing the likelihood that start-ups will be able to attract the talent that growth requires.

There is a growing body of academic research investigating the impact of capital gains taxes on entrepreneurship. Most studies focus on how a lower rate of return resulting from capital gains taxes affects the actors in the entrepreneurial process—the entrepreneurs and their financiers. New research has sought to better understand the impact of capital gains taxes on entrepreneurial innovation and the development of new ideas.

Professor James Poterba (1989a) provided the theoretical groundwork for examining the impact of capital gains tax policy on entrepreneurship. He highlighted an important link between capital gains taxes and the demand for venture capital funding—potential entrepreneurs compared the compensation obtained from employment at an established firm to the expected pay-off from a start-up where a larger share of their compensation would consist of a capital gain. Poterba concluded that, by changing the relative tax burden, a reduction in capital gains taxes would lead more high-quality people into entrepreneurship and increase the demand for venture capital.

Harvard economists Paul Gompers and Josh Lerner (1998) tested Poterba's theoretical assumptions by undertaking an empirical examination of the key drivers of venture capital funding. Analysing the stock of venture capital and tax rates on capital gains from 1972 to 1994, Gompers and Lerner found that a one percentage point increase in the rate of the capital gains tax was associated with a 3.8 percent reduction in venture capital funding.

Christian Keuschnigg and Soren Bo Nielsen (2003a) carried out a new theoretical study to understand what policies encourage individuals to seek regular employment and which ones lead them to pursue entrepreneurial activities (or enter the "entrepreneurial market" as the authors described it).⁶ Similarly to Poterba, the study found that capital income taxation reduces the supply of entrepreneurs in the market.

Keuschnigg and Nielsen later revisited this topic in two other studies. In Keuschnigg and Nielson (2004a), the authors investigated the effect that taxes (and other public policies such as subsidies to support new firms) had on the creation and success of businesses that were supported by venture capital. The authors found that "even a small capital gains tax ... diminishes incentives to provide entrepreneurial effort" (2004a: 1033). Keuschnigg and Nielson (2004b) look specifically at the effects that capital gains taxes have on start-up businesses, and how entrepreneurs react to this particular type of tax. The study concluded that capital gains taxes create significant obstacles for start-up businesses, since a capital gains tax "discourages managerial advice, raises venture returns, and retards entrepreneurship" (2004b: 24). Through this collection of studies, Christian Keuschnigg and Soren Bo Nielson presented a clear picture that illustrates the detrimental effect of capital gains taxes on entrepreneurial activities.

Donald Bruce and Mahammed Mohsin (2006) presented an empirical analysis of tax policy and entrepreneurship in the United States. The authors examined the effect of personal income tax rates, capital gains taxes, and corporate income tax rates on self-employment rates—a proxy for entrepreneurship. They found that a one percentage point reduction in the capital gains tax rate is associated with a 0.11 to 0.15 percentage point increase in the self-employment rate.

6 The entrepreneurial market refers to the entrepreneurial labour market, where households can choose to be either normal workers facing fewer risks and less returns, or entrepreneurs who face greater risks and higher returns.

Da Rin et al. (2006) examine the effect of a number of government policies on start-up business in 14 European countries between 1988 and 2001. The authors used two measures to determine whether policies were effective: (i) the proportion of high-technology investments to total venture investments (high-tech ratio), and (ii) the proportion of early-stage investments to total venture investments (early-stage ratio). The authors found that three policies were effective in increasing the proportion of high-tech and early-stage ventures: (1) opening a new venture stock market, (2) reducing the capital gains tax, and (3) reducing labour regulation.

Compliance costs, administrative costs, and tax avoidance

Capital gains taxes impose economic costs in the form of changing incentives for productive behaviour. But capital gains taxes also impose direct costs related to compliance and administration.

The Fraser Institute has published research that measures compliance costs such as expenses related to professional services and reporting, and calculating and remitting tax payments. Using survey data and multivariate analysis, this research estimates the extent to which different factors—such as socio-demographic characteristics, the use of different tax provisions, and different types of income including capital gains income—influence tax compliance costs. The most recent study (Speer & Palacios and Lugo & Vaillancourt, 2014) finds that individuals who reported capital gains income incurred, on average, higher compliance costs than those who did not report any such income. Specifically, the direct compliance costs for those individuals reporting capital gains income was, on average, 13.8 percent higher. This provides some sense of the compliance costs associated with capital gains taxation.

These findings are consistent with research in other jurisdictions on the compliance costs associated with capital gains taxes.

Blumenthal and Slemrod (1992) found that American taxpayers who received capital gains income incurred higher compliance costs than those who reported no such income. Using a survey of 2000 Minnesota households, the authors found that capital gains income increased the time that individuals spent complying with the tax system by 7.9 hours, increased the financial resources they spent on professional tax services by about \$21, and increased the total cost of compliance by \$143 (all figures in 1989 US dollars). Tran-Nam et al. (2000) found that capital gains taxes imposed significant costs on

Australian firms—6.8 percent of total income tax revenue collected (including income tax revenue generated from capital gains).

In addition to compliance costs for individuals, families, and businesses, there are also costs borne by governments in administering capital gains taxes, and ultimately these costs are covered by taxpayers. There is no empirical research on the administrative costs associated with capital gains taxes but the rules and regulations related to the capital gains tax regime require tax collection agencies to dedicate resources to their enforcement. These administrative costs ought to be considered when conceptualizing the total cost of taxation.

Capital gains taxes also contribute to tax avoidance. The level of tax avoidance is the extent to which actual tax revenue collected by a government differed from what would have been collected if every taxfiler paid exactly what is required by law. Tax avoidance has important implications for tax efficiency since resources expended on avoidance could be put to more productive uses.

Poterba's study in the *American Economic Review* (1987) was a path-breaking work in measuring the relationship between capital gains taxes and tax avoidance. He found that capital gains taxes have a significant effect on tax avoidance. In particular, he found that a 1.0 percent decrease in the capital gains tax rate increased the reported tax base by 0.4 percent. In addition, he estimates that for a taxpayer with an income of \$100,000 and capital gains of \$20,000, a reduction in his or her tax rate from 45 percent to 33 percent (as set out in the US Tax Reform Act of 1986) would reduce the probability of tax avoidance from 72 percent to 55 percent.

A study by Wayne Landsman, Douglas Shackleford, and Robert Yetman (2002) supports his findings with evidence from a unique data set of shareholder information from the 1989 leveraged buyout of RJR Nabisco. The authors estimate that a one percentage point increase in the marginal tax rate on capital gains is associated with a 0.42 percent increase in tax avoidance. They also found that the average level of avoidance was 11 percent of total gains capital.

At present there are no specific estimates of the extent to which Canadian taxfilers avoid capital gains taxes. But the international evidence suggests that there is indeed some degree of avoidance associated with capital gains taxes.

Marginal efficiency cost

All taxes impose efficiency (economic) costs on society because they distort the behaviour of individuals, families, and businesses. Numerous studies—both academic and commissioned by governments—have estimated the economic costs of different types of taxes. The research relies on what is referred to as the marginal efficiency cost. This methodology provides a means to estimate the cost of different taxes by calculating the efficiency cost of raising one additional dollar of revenue. The goal is to understand what types of different taxes impose the least cost on the economy.

As discussed, the evidence shows that capital gains taxes bring considerable economic costs. This type of taxation reduces the after-tax rate of return on capital investments, creates an incentive for investors to hold onto current assets even though more profitable and productive investments exist, and lowers the return that entrepreneurs, venture capitalists, and other investors derive from risk-taking, innovation, and work effort. These diminished incentives caused by capital gains taxes impede the turnover of older, less profitable investments, reduce the supply of entrepreneurs and the investors that finance them, and reduce the overall level of accumulated capital.

The empirical literature on marginal efficiency cost finds that capital-based taxes impose greater economic costs than other forms of taxation. One of the most widely cited calculations of marginal efficiency costs are those by Dale Jorgensen and Kun-Young Yun (1991). The authors estimate the marginal efficiency costs of select US taxes and find that capital-based taxes (such as capital gains taxes) impose a marginal cost of \$0.92 for one additional dollar of revenue compared to \$0.26 for consumption taxes.

The Canadian government's Department of Finance published a study by Baylor and Beausejour (2004) that calculated the long-term economic costs imposed by the main taxes in Canada. The authors estimated the benefits from a \$1 tax reduction for a number of different types of taxes, and their results support Jorgensen and Yun's findings for the US. Baylor and Beausejour find that a \$1 decrease in personal income taxes on capital (such as capital gains, dividends, and interest income) increases society's well-being by \$1.30; by comparison, a similar decrease in consumption taxes only produces a \$0.10 benefit.

The efficiency of taxation was also explored and discussed by the Quebec government's Ministry of Finance in the province's 2005–2006

budget. The report investigated the effects that different types of taxes have on the economy. The department found that a reduction in capital gains taxes yields more economic benefits than a reduction in other types of taxes such as sales taxes. Reducing the capital gains tax by \$1 would yield a \$1.21 increase in the GDP, whereas a decrease of \$1 in the sales tax would only increase GDP by \$0.54.⁷ This comparison exemplifies the economic benefits that are relinquished with significant capital gains taxation.

Canada's capital gains tax regime

Canada does not maintain a separate and distinct capital gains tax as capital gains are subject to income taxes. Depending on who holds the asset (individual or business), capital gains are taxed at either personal or corporate income tax rates.

The federal capital gains tax was introduced in 1971 in response to a report by the Royal Commission on Taxation (Carter Commission), which recommended that capital should be taxable like other forms of income. The first capital gains tax provided a preferential tax rate through what is referred to as an inclusion rate, the portion of a capital gain that is subject to income tax. The inclusion rate was set at 50 percent but later increased to 75 percent in 1990 where it remained for about a decade. The rate was lowered to two-thirds in February 2000 and then subsequently lowered back to 50 percent in October 2000 where it has remained to the present.⁸

Canada has a progressive personal tax system with tax rates increase according to income. This means that the most important rate is a taxpayer's marginal tax rate—the rate applied to the next dollar of one's income. **Table 1** shows, for 2014: (1) federal and provincial top marginal rates for personal income and the income thresholds at which they apply; (2) federal and provincial top marginal rates for capital gains tax; and (3) the combined federal-provincial top marginal rates for capital gains. As 50 percent of capital gains are included in taxable income, the marginal tax rate for capital gains is half the applicable income tax rate.

7 The GDP refers to the inflation-adjusted (real) GDP.

8 See Golombek (2012).

Table 1: Personal income tax rates and capital gains tax rates in Canada

	Personal income tax		Capital gains tax	
	Top marginal rate	Threshold for top marginal rate	Top marginal rate	Combined federal-provincial top marginal rate
Federal	29.00%	\$136,270	14.50%	—
British Columbia	16.80%	\$150,000	8.40%	22.90%
Alberta	10.00%	N/A *	5.00%	19.50%
Saskatchewan	15.00%	\$123,692	7.50%	22.00%
Manitoba	17.40%	\$67,000	8.70%	23.20%
Ontario **	20.53%	\$220,000	10.27%	24.77%
Quebec ***	20.97%	\$136,270	10.49%	24.99%
New Brunswick	17.84%	\$127,802	8.92%	23.42%
Nova Scotia	21.00%	\$150,000	10.50%	25.00%
Prince Edward Island**	18.37%	\$98,143	9.19%	23.69%
Newfoundland & Labrador	13.30%	\$68,508	6.65%	21.15%

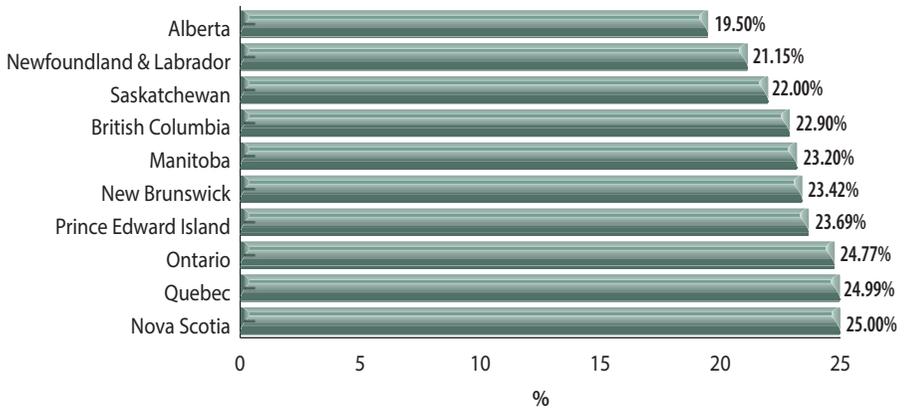
Note: * Alberta has a single 10% income tax for all personal income; therefore, the threshold for the top rate does not apply. ** Includes surtax. *** Includes Quebec abatement.

Source: <http://www.cra-arc.gc.ca/tx/ndvdl/fq/txrts-eng.html>.

While Canadians in all provinces face the same federal top personal tax rate on capital gains (14.5 percent), provincial rates vary greatly. Alberta had the lowest provincial top marginal capital gains tax rate in Canada at 5.0 percent. Quebec had the highest top provincial marginal capital gains tax rate at 12.9 percent.

The level of income at which the top provincial income tax rate applies also differs greatly among the provinces. Manitoba had the lowest threshold at which the top rate applied (\$67,000) while British Columbia (\$150,000), Nova Scotia (\$150,000), and Ontario (\$220,000) had the highest.

This is important because it means that Prince Edward Island's top marginal tax rate on capital gains applies much lower than in other provinces, since its top threshold is more than twice as low as that of provinces such as British Columbia and Nova Scotia. Alberta is the only province that has a single personal income tax rate applying to all levels of income. It is important to note that the new government in New Brunswick has expressed its

Figure 1: Combined federal-provincial capital gains tax rates, 2014

Source: <http://www.cra-arc.gc.ca/tx/ndvdl/fq/txrts-eng.html>.

intention to raise the province's top marginal personal income tax rate but has yet to enact the proposed changes.

Figure 1 shows the combined federal-provincial top capital gains tax rates in Canada for each province in 2014. Alberta had the lowest rate at 19.5 percent, with Newfoundland & Labrador (21.15 percent), and Saskatchewan (22.0 percent) ranking second and third. It is worth noting that this is an improvement for Newfoundland and Labrador. In 2006, its combined top marginal capital gains tax rate of 24.3 percent was the highest in the country. Nova Scotia's combined rate of 25.0 percent was the highest in 2014.

The amount of government revenue generated by capital gains taxation is not available to the public in government publications. Canadian governments lump tax revenues deriving from capital gains within the larger personal and corporate income tax categories in their budgets and annual reports.

According to the federal Department of Finance, in 2011, the federal tax revenue gained from capital gains taxation was \$2.8 billion compared with the revenue gained from all personal income taxes of \$120.5 billion and total revenue of \$249.1 billion.⁹ This means that capital gains taxes only represent 2.3 percent of the federal income tax revenue and 1.1 percent of overall federal government revenue.

⁹ The figures were obtained during an exchange between Fraser Institute researchers and the Department of Finance Canada, on May 30, 2014.

Experience with capital gains taxes in other jurisdictions suggests that higher capital gains taxes are self-defeating as a means of raising more revenue, and that lowering tax rates on capital gains can be positive for the tax base. Moore and Kerpen (2001) studied changes in capital gains tax rates in the United States over a thirty-year period and found a consistent pattern of revenue increases associated with capital gains tax reductions, and revenue declines with tax increases.

Capital gains taxes: equity questions

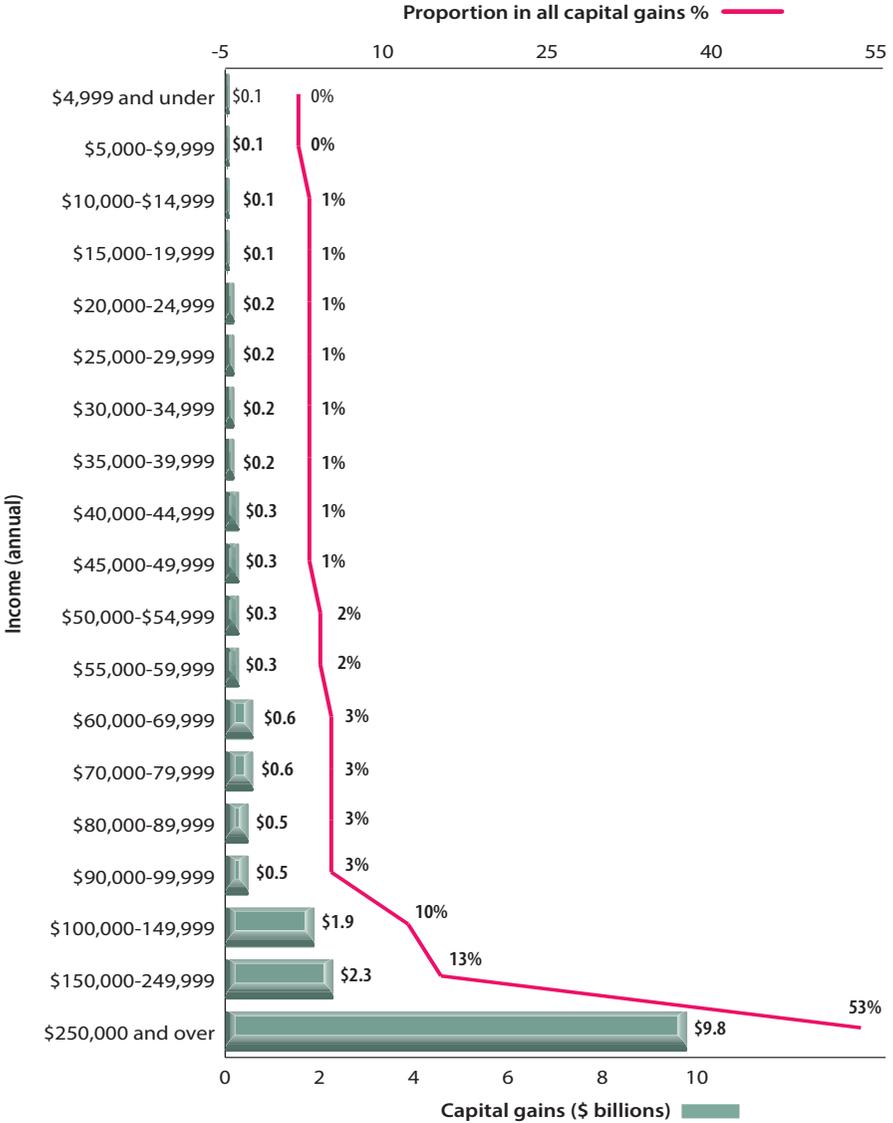
Yet in spite of the clear economic costs associated with capital gains taxation and limited government revenues, its proponents tend to support it on equity grounds. It is frequently claimed that only a small percentage of high-income earners realize capital gains, and the perceived unequal distribution of capital gains has in effect become the primary argument against capital gains tax reductions. As a Standing Senate Committee report summarized in 2000:

... the arguments in favour of lowering the capital gains tax are primarily economic. ... The arguments against a significant reduction in the capital gains tax are based primarily on the grounds that the direct effect of such a reduction has a disproportionate impact on higher-income taxpayers. (Parliament of Canada, May 3, 2000: Introduction)

This equity argument against capital gains tax reductions has been advanced by researchers in Canada and elsewhere. Daniel Feenberg and Lawrence Summers (1990), Jesper Roine and Daniel Waldenstrom (2012), and Thomas Hungerford (2013) have studied the capital gains income distribution in different jurisdictions and concluded that the concentration of capital gains with a small percentage of high-income earners is a source of inequality and a justification for maintaining capital gains taxes. Jackson (2004), Yalnizyan (2010), and Macdonald (2014) have reached similar conclusions about the income distribution of capital gains realizations in Canada and also argued for higher capital gains tax rates in order to offset the perceived inequity.

Government data on taxable capital gains are often cited as evidence of the unequal distribution. As per [figure 2](#), income statistics provided by the Canada Revenue Agency for 2011 show that Canadians earning \$250,000 or more reported 53 percent of taxable capital gains.

Figure 2: Taxable capital gains in Canada for 2011



Source: <http://www.cra-arc.gc.ca/gncy/stts/gb11/pst/fnl/pdf/tbl2-eng.pdf>.

There are problems with relying on tax data to evaluate the distribution of capital gains, however. The first issue is that a considerable percentage of Canadians receive capital gains in Tax-Free Savings Accounts (TFSAs), Registered Retirement Savings Plans (RRSPs), Registered Pension Plans (RPPs), and in their primary residences, but these capital gains are either non-taxable or are treated as regular income and therefore are not reflected in the tax data as capital gains. The point is that government policy already exempts capital gains from taxation for a large share of taxpayers in the name of encouraging investment, savings, and homeownership.

The TFSA was created in 2009 and allows for Canadians to contribute up to \$5,500 annually in a tax-free account. Any capital gains or dividends earned in a TFSA are non-taxable and therefore do not show up in taxable capital gains data. According to the Department of Finance (2013), approximately 8.2 million Canadians hold TFSAs with a total value of \$62 billion in assets. Analysis from the department found that, in 2011, more than 25 percent of the total value in TFSA contributions was made by individuals with incomes between \$20,000 and \$40,000, and more than 20 percent was made by individuals earning less than \$20,000. If capital gains incurred in TFSAs were accounted for, the distribution of capital gains would likely be less concentrated than suggested by the tax data.¹⁰

RRSPs are tax-preferred individual accounts designed to help Canadians save for retirement.¹¹ An individual's contribution is tax deductible. Current rules require individuals to convert their RRSP savings into Registered Retirement Income Funds (RRIFs) no later than the age of 71, and to begin drawing down the savings thereafter as part of their annual income (Canadian Revenue Agency, 2014). Any capital gains incurred in an RRSP are then taxed as regular income. This means that the individual does not benefit from the 50 percent inclusion rate for taxable capital gains. It also means that any capital gains incurred in RRSPs are not reflected in the tax data.

10 The current government has committed to increase the annual contribution limit to \$10,000 once the budgetary deficit is eliminated. One study (Milligan, 2012) considered the impact such a policy change would have on tax treatment of capital gains. The author found that raising the contribution limit would result in fewer than 4 percent of households reporting taxable capital gains income from savings in 20 years.

11 Individuals can contribute up to 18 percent of their earned income with a maximum of \$24,270 in 2014.

This likely has implications for the income distribution of capital gains. In 2011, 5.9 million Canadians contributed to an RRSP and the value of contributions that year was \$34.4 billion (Statistics Canada, 2014). In total, all assets held in RRSPs were valued at \$775 billion in 2011 (CBC, 2013). It is difficult to estimate the extent to which RRSPs holders are incurring capital gains in their respective accounts but it is likely that some percentage is and these data are not reflected in taxable capital gains.

RPPs are employment-based pension plans that are based on employee and/or employer contributions. Contributions are also tax deductible. A defined benefit or defined contributions are then distributed to plan participants during retirement. Any capital gains incurred in an RPP are then taxed as regular income. This means that the individual does not benefit from the 50 percent inclusion rate for taxable capital gains. It also means that any capital gains incurred in RPPs are excluded from the tax data.

This also likely has consequences for the income distribution of capital gains. According to Statistics Canada, 32 percent of the labour force in Canada participated in some type of RPP in 2011.¹² The total market value of all RPP assets in 2012 is \$1.3 trillion.¹³

In addition to TFSAs, RRSPs, and RPPs, capital gains realized from the sale of an individual's primary residence are not subject to taxation. The home ownership rate in Canada is now approximately 70 percent—among the highest rates in the industrialized world (Cross, 2014). Any data on the distribution of capital gains resulting from the sale of an individual's primary residence is excluded from the data on taxable capital gains.

The result is that a considerable percentage of capital gains income is earned in tax-sheltered vehicles. A 1999 Canadian study estimated that, as of 1989, roughly one-third of personal investment assets gave rise to income that is taxable under the income tax.¹⁴ The authors noted that the two-thirds value given for the proportion of personal investment assets not giving rise to

12 According to Statistics Canada (2013a), 6.1 million Canadian workers had RPPs in 2011, of which 3.1 million were employed in the public sector and 2.9 million in the private sector. In terms of percentages within the public and private sectors, 88.2 percent of employees in the public sector have RPPs and 24 percent in the private sector have access to RPPs (Palacios and Clemens, 2013).

13 See Statistics Canada (2013b).

14 See Poddar and English (1999).

taxable income was an underestimate, because the data for the components of household wealth was not comprehensive (it excluded offshore investments, for example) and it did not account for post-1989 trends in savings and investments. It also now excludes the enactment of TFSA's. Bibbee (2008: 32) estimates that approximately 90 percent of individuals will ultimately be able to hold all of their financial assets in tax-sheltered vehicles as the TFSA matures over time.

The second challenge with relying on tax data is that it includes taxable capital gains income in people's annual income, which inflates an individual's annual income due to one-time asset sales and contributes to the concentration of taxable capital gains among high-income earners. This method of presenting the income distribution of taxable capital gains therefore provides a flawed picture. By presenting income levels net any taxable capital gains, this method overstates the income distribution by pushing those with large one-time capital gains into higher income groups. But these gains are often atypical and can create a misleading picture about the income levels of those who incur capital gains. For instance, the owners of a small business may have lower incomes and reinvest earnings back into their business to build up a nest egg for retirement. It will appear that in the tax year such people sell their business and retire they are high-income earners, even though it is a one-time spike in their personal income. Put simply, the lumpy nature of asset dispositions results in statistics on the incomes of those with capital gains that tend to overstate their wealth.

A more appropriate measure of the distribution of taxable capital gains would be pre-taxable capital gains income. Grubel (2003) discussed in detail economist Joel Emes's attempt to understand the extent to which the current method affected the income distribution of taxable capital gains. With data from Revenue Canada, Emes found that, in 1992, 78 percent of capital gains taxes were paid by families with incomes above \$100,000, and that only 8 percent were paid by families with incomes below \$50,000. Backing out capital gains income, however, changed the income distribution considerably. Using this method, Emes found that families with income above \$100,000 paid 26.8 percent of capital gains taxes and those with incomes below \$50,000 paid 52.1 percent of such taxes. A similar analysis for 2010 finds a comparable

distributional breakdown after accounting for pre- and post-taxable capital gain income.¹⁵

Concern about the income distribution of capital gains ignores the fact that a significant number of Canadians across income scales realize capital gains even if these are not reflected in the tax data. Any debate about the equity of capital gains taxes therefore needs to account for this reality. Tax policy can sometimes involve important trade-offs between the principles of equity and economic efficiency and any debate about capital gains taxes should not overstate the potential equity concerns.

Lessons from abroad

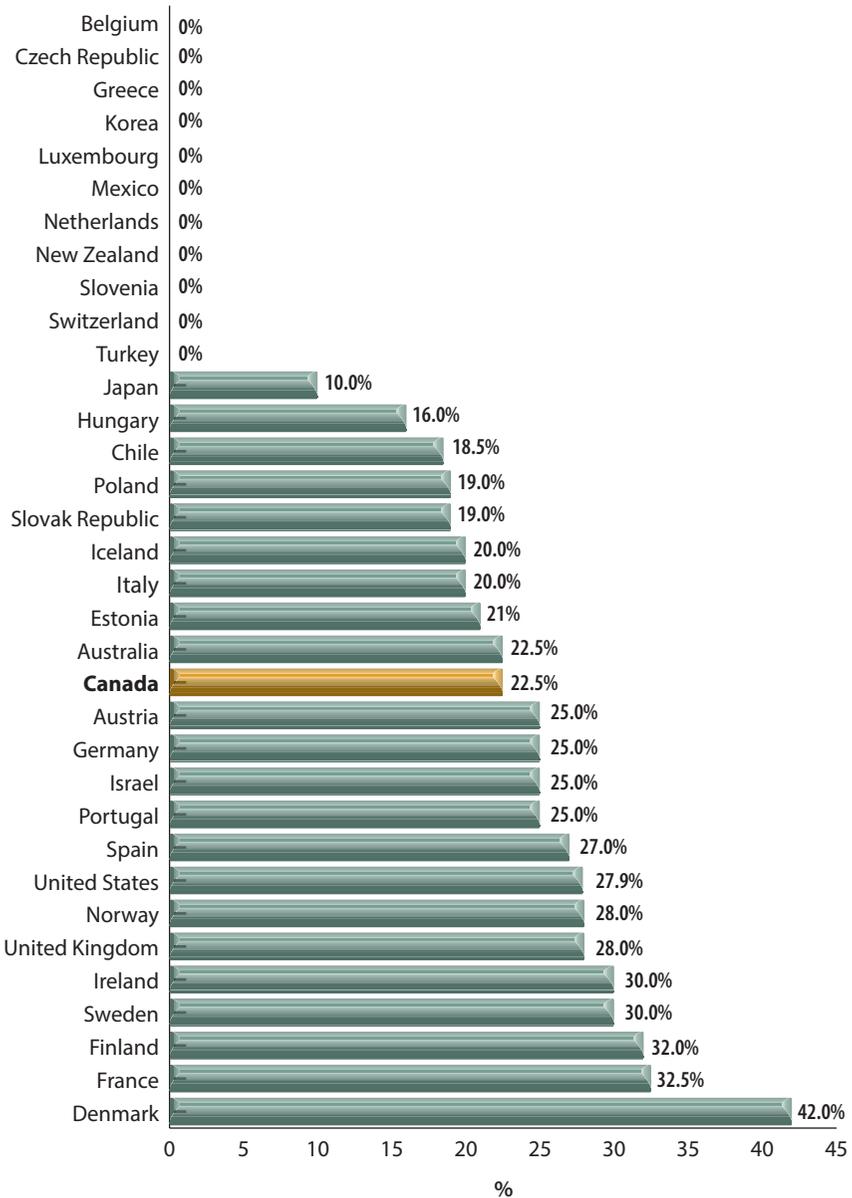
The structure and rates of capital gains vary considerably by country. Some countries have a separate and distinct tax on capital gains. Others such as Canada tax capital gains through the regular income tax system. The rates of tax and levels of income at which those rates apply also differ among countries.

Figure 3 shows the top personal capital gains tax rates in 2013 for 34 countries comprising the Organisation for Economic Co-operation and Development (OECD). Eleven of those countries do not levy personal capital gains taxes. Canada has the fourteenth highest personal capital gains tax rate among these countries, at 22.25 percent. The United States ranks eighth highest with a capital gains tax rate of 27.9 percent. Denmark has the highest capital gains tax rate of 42 percent.

As in the discussion of Canadian provinces, it is important to note that capital gains tax rates presented in Figure 3 apply at different levels of income in the various countries. That is, while the tax rates may be the same in two countries, the level of income at which those rates apply could be markedly different.

15 Further analysis using panel data to track incomes and tax payments over time could allow one to examine these results over a multi-year period.

Figure 3: OECD top capital gains tax rates, 2013



Source: <http://taxfoundation.org/article/top-capital-gains-tax-rate-oecd-2011-2014>.

Conclusion

As the economic literature shows, capital gains taxes carry considerable economic costs. The empirical research finds that capital gains taxation can have a substantial impact on the reallocation of capital, the stock of capital, and the levels of entrepreneurship. The ultimate outcome is less investment and less economic activity.

These economic costs have to be measured against the tax revenue that capital gains taxation generates and how such a policy affects the tax system's overall efficiency and equity. Neither consideration outweighs the high costs that capital gains taxes impose on the economy.

As discussed, capital gains tax revenue represents only 2.3 percent of the federal income tax revenue and 1.1 percent of overall federal government revenue. It seems hard to justify the current capital gains tax regime with its high economic costs in exchange for such a relatively small revenue source.

As for equity considerations, the argument in favour of capital gains taxes is weaker than commonly presented. Government policy already exempts capital gains from taxation for a large share of taxpayers in the name of encouraging investment, savings, and homeownership. It is also the case that tax data reflects net income—including any one-time taxable capital gains, which cause individuals to be pushed into higher income groups than would normally be the case. Concerns about the income distribution of capital gains therefore ignore the fact that a significant number of Canadians across income scales realize capital gains even if it is not reflected in the tax data. Any debate about the equity of capital gains taxes therefore needs to account for this reality. Tax policy can sometimes involve important trade-offs between the principles of equity and economic efficiency, and any debate about capital gains taxes should not overstate the potential equity concerns.

In sum, this essay has reviewed the economic literature on capital gains taxes and sought to contextualize Canada's current tax treatment in this body of research. It has also addressed common arguments in favour of maintaining high capital gains tax rates—namely the revenue implications and equity concerns—and shown that the trade-off between the high economic costs of capital gains taxes and these considerations would point in the direction of further capital gains tax reform. In so doing, the essay sets the foundation for readers to evaluate subsequent chapters on capital gains tax regimes in different countries.

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About the authors

Jason Clemens

Jason Clemens is the Fraser Institute's Executive Vice-President. He held a number of positions with the Fraser Institute between 1996 and 2008, including Director of Research Quality, Director of Budgeting and Strategic Planning, and Director of Fiscal Studies. He most recently worked with the Ottawa-based Macdonald-Laurier Institute (MLI) as Director of Research and held a similar position with the San Francisco-based Pacific Research Institute for over three years. Mr. Clemens has an Honours Bachelors Degree of Commerce and a Masters Degree in Business Administration from the University of Windsor as well as a Post-Baccalaureate Degree in Economics from Simon Fraser University. He has published over 70 major studies on a wide range of topics, including taxation, government spending, labour market regulation, banking, welfare reform, health care, productivity, and entrepreneurship. He has published nearly 300 shorter articles, which have appeared in such newspapers as the *Wall Street Journal*, *Investors' Business Daily*, *Washington Post*, *Globe and Mail*, *National Post*, and a host of other US, Canadian, and international newspapers. In 2012, the Governor General of Canada, on behalf of Her Majesty the Queen, presented Mr. Clemens with the Queen Elizabeth II Diamond Jubilee Medal in recognition of his contributions to the country.

Charles Lammam

Charles Lammam is Associate Director of Tax and Fiscal Policy at the Fraser Institute. Since joining the Institute, Mr. Lammam has published over 35 peer-reviewed studies and 150 original commentaries on a wide range of economic policy issues including taxation, government finances, pensions, investment, income mobility, labour, entrepreneurship, public-private partnerships, and charitable giving. His commentaries have appeared in every major national and regional newspaper in Canada (including the *Globe and Mail* and *National Post*) as well as prominent US-based publications (including *Forbes* and *The American*). Mr. Lammam regularly gives presentations to various groups, comments in print media, and appears on radio and television broadcasts across the country to discuss the Institute's research. He has appeared before committees of the House of Commons as an expert witness. Mr. Lammam holds an M.A. in public policy and a B.A. in economics with a minor in business administration from Simon Fraser University.

Matthew Lo

Matthew Lo was a 2014 research intern at the Fraser Institute. He is currently studying his Master's Degree in Economics at the University of British Columbia.

Taxing Consumption, Not Saving: New Zealand's Rejection of a Comprehensive Capital Gains Tax

Stephen Kirchner

New Zealand is one of the few developed economies not to have a general capital gains tax, although some transactions that yield capital gains are subject to income tax. The current tax system is the result of a radical and comprehensive tax reform process from the 1980s which left New Zealand with one of the world's most efficient tax systems. Although there has been some backsliding in the last decade, New Zealand still ranks second in the Tax Foundation's global rankings of international tax competitiveness (Pomerlau and Lundeen, 2014: 5).

The most significant tax reform was the introduction of a 10 percent goods and services tax (GST) in 1986. The GST rate was subsequently raised to 12.5 percent in 1989 and 15 percent in 2010. The tax reform process has focused on shifting the tax burden on to consumption rather than saving, and lowering the efficiency cost of the overall tax burden. As a small open economy with highly mobile labour and capital, New Zealand policymakers face stronger external disciplines and constraints than other larger, relatively closed economies. In particular, the free trade agreement with Australia means that New Zealand faces strong competition for mobile factors from its nearest neighbour. New Zealand's focus on taxing consumption and its seemingly anomalous tax treatment of capital gains is readily explicable in this context.

The introduction of a comprehensive capital gains tax has been considered many times over recent decades in the context of official reviews of the tax system. These reviews have generally found that the efficiency and

other costs of a comprehensive CGT outweigh potential benefits in addressing anomalies and distortions arising from the existing approach to taxing capital gains. Political considerations and potential popular opposition have also been important in steering policymakers away from a general CGT. The lack of a comprehensive CGT is not an oversight but a deliberate policy choice that has been reiterated throughout the tax reform process that began in the mid-1980s.

The failure to introduce a comprehensive CGT is all the more remarkable given that the tax reform process in New Zealand has been informed by the Haig-Simons conception of a comprehensive income tax base that seeks to tax changes in real wealth. This approach generally favours comprehensive taxation of capital gains. This is an interesting contrast to Australia, where the 2010 Henry tax review explicitly repudiated the Haig-Simons conception of comprehensive income taxation in favour of an expenditure tax benchmark derived from the optimal tax literature (Commonwealth of Australia, 2010). The optimal tax literature generally argues against capital taxation as distorting for consumption-saving decisions.

The Henry review argued for the concessional treatment of capital gains and other forms of income derived from saving in Australia. Ironically, the recommended approach was somewhat less generous in its treatment of capital gains than Australia's existing CGT regime. The Henry review's recommendations have for the most part not been implemented. However, the review was nonetheless important in discrediting Haig-Simons principles and changing the terms of public debate about tax reform. The New Zealand debate over CGT taxation is still largely conducted in Haig-Simons terms. Yet even taking the Haig-Simons approach as the starting point for analysis, New Zealand policymakers have been reluctant to embrace a comprehensive CGT on pragmatic grounds. As Slemrod notes, "the leap from the blackboard to the real world is a large one when it comes to taxation" (1991: 17). Tax policy needs to recognise the constraints imposed by the technology available for collecting taxes and that the resource costs of collecting taxes can be large. Political feasibility constraints also need to be taken into consideration. Idealised systems of optimal taxation may not be efficient in the presence of these constraints.

This paper first sets out the ways in which capital gains are taxed in New Zealand. The second section outlines the history of the tax reform process and how it has addressed the issue of capital gains taxation. The third

section addresses the problems said to be caused by the absence of a comprehensive CGT and why these problems have not been thought to be sufficiently compelling to warrant its introduction. The fourth section compares New Zealand to other countries in terms of key variables that might be influenced by the taxation of capital gains. While New Zealand underperforms on the basis of some of these indicators, this underperformance is unrelated to the absence of a comprehensive capital gains tax and could be made worse by its introduction. The paper concludes by noting that the New Zealand debate over tax reform and CGT largely parallels that found in other countries. Most of the arguments made in favour of a comprehensive CGT are non-economic arguments grounded in principles of equity rather than economic efficiency. The difference in policy outcomes reflects New Zealand's unique political and economic circumstances as a small open economy rather than fundamental differences in thinking about taxation.

How New Zealand taxes capital gains

New Zealand does not have a general or comprehensive capital gains tax. However, some transactions that yield capital gains are subject to income tax depending on the nature of the transaction and the purposes of the taxpayer. The existing Income Tax Act 2007 references the concept of “ordinary income,” which is taxable, and other income, which is generally non-taxable. There is no comprehensive definition of income in the legislation. Income on the revenue account is taxable, while receipts of a capital nature are generally exempt from taxation unless otherwise provided for in the Act (New Zealand, 2009: 26). Specific capital receipts are taxed, mainly where the dominant purpose of the original acquisition is deemed to be resale.

For example, dealers in land and property, builders, and developers are subject to taxation of capital gains, whereas home owners and property investors are not. Property investors can also deduct losses arising from their ownership of the property against ordinary income, but owner-occupiers cannot, consistent with imputed rent being untaxed. Financial instruments, foreign shares, and some intellectual property are also taxed depending on the entity making the investment, the location and period of the investment, and the intentions of the investor.

The capital/revenue boundary that determines whether capital gains are taxable relies on a mix of ad hoc legislative provision and judicial interpretation. This has been labelled the “pragmatic approach” to taxing capital gains in that it does not reference the Haig-Simons notion of comprehensive income, changes in real wealth, or other principles. The result is a hybrid system in which some capital gains are untaxed, some are taxed on an accruals basis, and others on a realization basis.

This ad hoc approach to taxing capital gains creates both uncertainties and anomalies, especially in defining the location of the capital/revenue boundary. It is also said to give rise to costly complexity and opportunities for avoidance.¹ In failing to tax saving via housing, it is said to skew the tax system in favour of investment in housing and home-ownership. However, as will be argued below, many of these problems have their origins in other aspects of the tax system, while the introduction of a CGT would create its own difficulties.

CGT in the context of New Zealand's radical tax reforms

It is difficult to over-state the radical nature of the tax reform process that New Zealand embarked upon in 1984. Indeed, the New Zealand Treasury went so far as to consider a direct personal expenditure tax and a cash flow business tax as the basis for a new tax system. These proposals were dismissed, but only for pragmatic reasons. As a small open economy then subject to severe external and internal economic pressures, it was considered too dangerous for New Zealand to go out on a limb with a radical tax system that had no international precedents (White, 2009: 111). Instead, the focus of the tax reform process turned to a comprehensive, single rate goods and services tax that would alleviate the tax burden on saving and increase economic efficiency. New Zealand's GST is widely recognised as one of the world's most efficient. Its consumption efficiency (that is, the ratio of GST revenue to aggregate consumption times the GST rate) is close to 100 percent, much higher than in other OECD countries with similar consumption taxes (White, 2009: 112).

1 Many of these problems are reviewed in Oliver (2001).

New Zealand raises 39 percent of tax revenue from taxes on goods and services compared to 24.4 percent for Canada and 17.9 percent for the US.²

The 1987 Brash Committee recommended the introduction of a comprehensive CGT as a way of broadening the tax base, with a view to keeping tax rates low while reducing government expenditure (Brash Committee, 1987). However, the committee was not unanimous in its support for a comprehensive CGT and noted many potential problems. There was a particular concern that a realizations-based CGT might have a lock-in effect, reducing the agility of capital at a time when the New Zealand economy was experiencing a major restructuring (White, 2009: 122). A general CGT, together with the indexation of the tax base, was subsequently proposed by the government in 1989, but these proposals did not proceed, largely for political reasons.

The 2001 McLeod Committee review of the tax system concluded that “we do not consider that New Zealand should adopt a general, realizations-based capital gains tax. We do not believe that such a tax would make our tax system fairer and more efficient, nor do we believe that it would lower tax avoidance or raise substantial revenue that could be used to reduce rates. Instead, such a tax would increase the complexity and costs of our system” (New Zealand, 2001: iii). The review instead recommended a continuation of the “pragmatic approach” to address any anomalies. It also recommended the adoption of a risk free return method (RFRM) as a way of resolving the disparate tax treatment of different saving vehicles.³ The RFRM would have taxed the net equity component of owner-occupied and rental housing, but this option was not pursued given an expected lack of public support.

The 2010 report of the Victoria University of Wellington Tax Working Group (TWG) assessed the case for a comprehensive CGT, noting many of the difficulties associated with both accruals and realization-based approaches to taxing capital gains. The report concluded that “most members of the TWG have significant concerns over the practical challenges arising from a comprehensive CGT and the potential distortions and other efficiency implications that may arise from a partial CGT” (2010: 11). The report recommended an

2 See *OECD Tax Statistics* at <<http://dx.doi.org/10.1787/taxrev-sector-table-2013-1-en>> (last updated 17 January, 2014).

3 The RFRM method calculates tax owed based on the formula, *net asset value at the start of the year times statutory risk-free real rate of return times investor's tax rate*.

increase in the GST rate to 15 percent to reduce biases in the tax system against saving and investment, a measure that was adopted in the government's 2010 budget. This is consistent with the TWG's observation that "New Zealand's tax base will need to be less reliant on internationally mobile factors such as the incomes of capital and skilled labour" (2010: 10). It should be noted that New Zealand's Treasury supported the introduction of a comprehensive CGT in the lead-up to the 2010 Budget. A comprehensive CGT is not completely lacking in official sector support. The New Zealand Labour Party proposed a 15 percent CGT that excluded owner-occupied housing at the 2014 general election, but was defeated.

The introduction of a comprehensive CGT has thus been considered on many occasions during the tax reform process that began in 1984. There is some official sector support for base-broadening via a more general approach to taxing capital gains. However, there has been diminishing support for the introduction of a comprehensive CGT in recent official tax reviews compared to those conducted in the late 1980s, when the government last proposed its introduction. The absence of a comprehensive CGT is thus a considered policy choice on the part of successive New Zealand governments, not a historical accident or oversight. This outcome is all the more remarkable given that the tax reform process in New Zealand has been largely informed by a comprehensive income view of taxation that is normally seen as supportive of taxes on capital gains. However, it is consistent with the theory of optimal tax systems proposed by Slemrod (1991), "a normative theory of taxation that ... takes seriously the technology of collecting taxes." New Zealand policymakers have acknowledged the difficulties in translating idealised tax systems into practical policy recommendations.

Is the absence of a comprehensive CGT a problem?

Despite its rejection in official reviews of the tax system, a comprehensive CGT still has its supporters in New Zealand. They point to several problems caused by the absence of such a tax. These include anomalies and complexity in the tax system, potential for avoidance, loss of revenue, equity concerns, and over-investment in housing. Each of these potential problems is examined below.

Anomalies and complexity

The hybrid and somewhat ad hoc nature of New Zealand's "pragmatic approach" to taxing the returns to capital gives rise to some anomalies and complexity in the administration of the tax system. This in turn may reduce economic efficiency.

The most frequently cited anomalies relate to the different tax treatment that applies to the taxation of different types of saving depending on the saving vehicle and the taxpayer. This is seen as particularly problematic from the comprehensive income view of taxation, which aims to tax all income at the same rate on both equity and efficiency grounds. However, it is less problematic from the perspective of the optimal tax literature, which rejects on efficiency grounds the notion that income from labour and income from capital need to be taxed at the same rate. In this framework, the taxation of capital is viewed as particularly problematic because it distorts consumption and saving decisions over time. Because saving and investment are deferred consumption, taxes on saving and investment tax future consumption at a higher rate than current consumption. Concessional tax treatment of saving reduces this distortion while the non-taxation of saving can eliminate it entirely.

By the end of the 1980s, New Zealand's company, trustee, and top personal income tax rates were aligned at 33 percent. New Zealand then had one of the world's most efficient tax systems and one of the lowest corporate tax rates. Subsequent increases in personal income tax rates to 38 percent by the Fifth Labour Government in 2000 increased the incentive for individuals to shelter income in companies, trusts, and other saving vehicles. Cuts in foreign company tax rates rendered New Zealand's corporate tax rate increasingly uncompetitive, resulting in a cut to 28 percent in the 2010 budget. The top marginal personal income tax rate was also lowered to 33 percent. This creates a potential anomaly in the taxation of dividends versus retained earnings. However, this is more of an argument for aligning tax rates at lower rates than the introduction of a comprehensive CGT.

In principle, a comprehensive CGT could address some of these anomalies and complexity, but would almost certainly introduce new problems. Experience with realization-based CGT regimes in other countries, not least Australia, demonstrates that they are not without their own anomalies and complexity (Kirchner, 2011). Taxing capital gains is inherently complex and

is made more so because CGT regimes are vulnerable to exemptions and tinkering and have high compliance and collection costs. Overseas experience with actual as opposed to idealised CGT regimes has weighed heavily on New Zealand policymakers in their consideration of the merits of a comprehensive CGT.

Tax avoidance

There is a commonly held belief that the failure to tax capital gains provides some taxpayers with the opportunity to convert ordinary income into capital gains and thereby avoid tax. As even the advocates of CGT readily concede, “the essential role of the CGT is not therefore to raise revenue. It is to act as a “backstop” to the income tax system—to act as an integrity measure” (Evans, 2002: 118). The 1985 Draft White Paper on the Reform of the Australian Tax System (RATS), which paved the way for the introduction of a comprehensive CGT, argued that the absence of a CGT was “at the core of many avoidance arrangements” (Australia, 1985: 78). Yet no estimates have been made of the additional revenue this anti-avoidance measure is supposed to have captured in Australia (Freebairn, 2001: 128).

The New Zealand approach has been to close potential loopholes on an ad hoc basis if and when they pose a threat to the revenue. Tax avoidance schemes are typically the result of high marginal tax rates that make such schemes profitable. Low tax rates are the best way to render such schemes uneconomic.

The incentive to convert income into capital gains does not necessarily translate into the ability to do so, and the opportunity for avoidance via this mechanism is asserted far more often than it is demonstrated. In any event, a realizations-based CGT is a largely voluntary tax that is easily avoided by not realizing the gain or realizing gains when other income and tax rates are low. Taxable assets will also be diverted into the hands of those with low tax rates (the tax clientele effect). Reductions in capital gains tax can yield increases in tax revenue because of an increase in realizations—in other words, a reduction in tax avoidance. To the extent that lower rates of CGT induce increased realizations that would otherwise go untaxed, this results in more revenue being collected from taxpayers.

Loss of revenue

The absence of a comprehensive CGT may lead to a loss of revenue apart from any opportunities for tax avoidance, potentially resulting in higher rates of taxation on other tax bases with resulting losses in economic efficiency. The TWG estimated that a comprehensive accruals-based CGT on nominal gains could raise around NZD 9 billion in 2009–10 prices at then-prevailing tax rates. This would fall to NZD 4.5 billion if, as would seem politically very likely, owner-occupied housing were excluded, and would fall even further at lower tax rates (TWG, 2010: 45). To put this in perspective, nominal GDP for the March year 2010 was NZD 190.429 billion, so a comprehensive CGT would raise revenue equal to around 4 percent of GDP at then prevailing tax rates. However, these estimates almost certainly overstate likely revenue gains given the probability that owner-occupied property would be exempt and any tax would be levied on a realization rather than accrual basis. In the long run, realization- and accruals-based CGT regimes should raise the same revenue, but only if capital gains and losses are treated symmetrically. These estimates also make no allowance for inflation, including house price inflation, which was particularly strong at the time they were prepared. Even on Haig-Simon principles, CGT should be adjusted for inflation to ensure that only real additions to net worth are taxed.

It should also be noted that these are static, not dynamic, estimates of potential revenue gains. The effects of changes in tax rates on capital gains realizations and revenue are difficult to determine given the difficulty of accounting for possible behavioural responses on the part of taxpayers. The international empirical literature exhibits mixed results on this question (Zodrow, 1995). Because of its relationship to asset price and economic cycles, CGT revenue can exhibit considerable volatility. For example, in Australia, CGT is on average only around 3 percent of total tax receipts, but has been responsible for 20 percent of the forecasting error for tax receipts in the budget year (Clark, 2014: 37). This may induce governments to increase permanent spending based on temporary increases in CGT revenue. Base-broadening measures can also lead to increased inefficiency due to an induced expansion in the size of government that offsets the efficiency gains from lower tax rates (Becker and Mulligan, 2003). This induced expansion in the size of government potentially renders inefficient increases in even supposedly neutral, lump-sum taxes. As Brennan and Buchanan (1980) have argued,

public opposition to base-broadening measures is a rational response to concerns that a notionally more efficient tax system may reduce constraints on the expansion of the size of government. New Zealand policymakers have instead put greater reliance on consumption taxes to achieve a broad-base, low-rate tax system that provides relatively stable sources of revenue at a low efficiency cost.

Equity

The rationale for taxing capital gains is based on the Haig-Simons view that the tax base should incorporate the broadest possible definition of income, including additions to real net worth. The Haig-Simons view is largely based on notions of equity rather than efficiency and has its origins in legal rather than economic reasoning.

Horizontal equity maintains that all income, including additions to net worth, should receive the same tax treatment, regardless of how it is derived (or more simplistically, that “a buck is a buck”). However, as former Australian Treasury Secretary Ken Henry has noted, “the logic of income from all sources ... being subject to a common progressive tax schedule is now widely accepted to be flawed” (Henry, 2009). The comprehensive income view ignores the fact that saving and investment takes place out of after-tax income. Taxing income arising from saving and investment amounts to double taxation. Since an asset’s capital value is the discounted value of its future income stream, the returns to the asset are taxed twice. CGT is applied to the disposal of an asset, while the yield of an asset is also taxed as ordinary income. This double taxation not only discourages saving but rewards the accumulation of debt, because debt reduces the additions to net worth that the Haig-Simons concept of income seeks to tax.

Capital losses are typically not treated symmetrically with capital gains, with the latter added to ordinary income for tax purposes, while the former can only be offset against other capital gains. While this is designed to prevent some forms of tax arbitrage and minimization, this is also one of the ways in which capital gains are treated differently to ordinary income, contrary to the notion of horizontal equity that is supposed to underpin the Haig-Simons conception of taxation. Few developed countries tax capital gains at the same rate as ordinary income. Australia taxed real (i.e., inflation-adjusted) gains at marginal tax rates between 1985 and 1999, although averaging was applied to

lower effective marginal rates. This internationally anomalous treatment of capital gains was remedied by the 1999 Ralph business tax review through a 50 percent capital gains tax discount, but on nominal rather than real gains. This tax treatment is concessional, but only so long as nominal rates of return on assets exceed the inflation rate. The 2010 Henry review in Australia recommended an across the board 40 percent discount be applied to income derived from saving, including capital gains and net rental income, but this recommendation has not been adopted.

CGT is also motivated by considerations of vertical equity, the view that the wealthy should pay proportionally more tax. While it is true that capital gains tend to be concentrated at the upper end of the income distribution, so are capital losses. Net capital gains are thus more correctly viewed as compensation for bearing risk that can be left untaxed without compromising efficiency or equity. The tax system is a particularly inefficient way to promote vertical equity objectives. The relatively flat income distribution of taxpayers in New Zealand does not allow much redistribution to occur through tax rate scale progression (New Zealand Treasury, 2001: vii). Most income redistribution in New Zealand occurs via government spending, which is the more appropriate vehicle for such policies. The tax system should instead focus on raising revenue at the lowest efficiency cost.

Over-investment in housing and housing affordability

Whether the absence of a CGT is considered a tax concession or subsidy depends on the benchmark tax system used. Based on an expenditure tax benchmark, the absence of a CGT is neither a tax concession nor a subsidy to homeownership. Indeed, it reduces a distortion in the tax system that would arise from taxing saving, which distorts the intertemporal price of consumption. However, the absence of a CGT will also interact with other elements of the tax system. The tax-free status of capital gains on owner-occupied and investment property makes property ownership a preferred savings vehicle for most New Zealanders. However, New Zealand is not exceptional in this regard, with most comparable countries taxing owner-occupied housing on a concessional basis. Homeownership is high by international standards, at 64.8 percent of households, but still somewhat lower than Australia at 67 percent and Canada at 69 percent (see, respectively: Statistics New Zealand, 2013a; Australian Bureau of Statistics, 2012; Statistics Canada, 2013).

Homeownership in New Zealand is on a declining trend, which may reflect reductions in housing affordability flowing from higher house prices, but New Zealand is not exceptional in this regard, with homeownership in Australia also on a declining trend, especially among younger age groups (Australian Bureau of Statistics, 2013).

Saving via housing is a rational response to differences in tax treatment of different asset classes. However, it also points to the fact that tax incentives provide a mechanism that can be used to promote saving. The problem is not so much that housing is taxed too lightly, but that saving via other asset classes is taxed too heavily. Tax reform should focus on alleviating the tax burden on saving and investment, regardless of asset class. This would tend to eliminate any distortion in favour of housing and other assets that currently receive relatively favourable tax treatment. New Zealand's increased focus on taxing consumption alleviates such distortions, although it does not entirely eliminate them.

Realization-based capital gains taxes are a tax on transactions and could be expected to reduce turnover in the housing market and create lock-in effects that would reduce efficiency in the allocation of the housing stock, as well as reducing labour mobility. It should be noted that CGT concessions benefit the supply as well as the demand sides of housing markets, leaving their net implications for house prices and housing affordability theoretically ambiguous and empirically difficult to discern. John Freebairn has argued in the Australian context that the benefits of capital gains tax concessions "fall primarily on the supply-side" of the housing market (2009: 12).

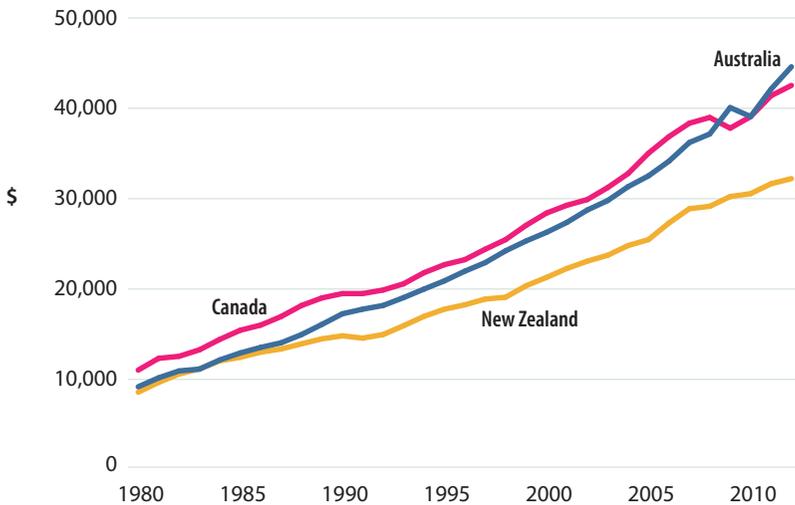
Many countries with comprehensive capital gains taxes exempt owner-occupied housing (e.g., Australia) or provide generous relief (e.g., the US). This arguably creates a stronger bias in favour of saving via housing than in New Zealand where capital gains are generally exempt from tax. Housing affordability problems in countries like New Zealand and Australia are driven largely by supply-side constraints such as the tax burden on new housing (as opposed to saving via housing) and planning and development controls. These supply-side constraints prevent housing markets from accommodating the increases in demand driven by rising populations, rising incomes, and increased debt serving capacity from reductions in real interest rates. In principle, this demand could be met through increased supply without putting upward pressure on house prices, but in practice the tax and regulatory burden on new housing supply has led to higher prices.

The solution to New Zealand's housing affordability problem is to increase supply-side flexibility and not to increase the tax burden on saving via housing. As Australia's Henry tax review noted, "the tax system is not the appropriate tool for addressing the impact of other policies on housing affordability" (Commonwealth of Australia, 2010: 420). Taxing capital gains on owner-occupied housing and investment property could even give government a perverse incentive to restrict supply to increase house prices and thus CGT revenue.

New Zealand's economic, saving, and investment performance

The absence of a general CGT could be expected to have a number of economic benefits. These include higher rates of saving, investment, productivity and economic growth, and increased entrepreneurial risk-taking, all else being equal. However, all else is not equal. New Zealand underperforms comparable developed countries on some of these indicators. This is despite the generally high quality of New Zealand's economic, political, and other institutions. New Zealand ranks near the top of the economic freedom indices compiled by the Heritage Foundation (ranked 5th in 2014) and the Fraser Institute (ranked 3rd in 2014).⁴ Based on New Zealand's institutional quality, GDP per capita should be around 20 percent above the OECD average, but it is in fact about 20 percent below average and below that of comparable economies such as Australia and Canada (**figure 1**). This productivity puzzle can be largely explained by New Zealand's small scale (population 4.5 million) and distance from major markets (New Zealand Productivity Commission, 2014). A still-extensive welfare, state including a universal age pension scheme, also weighs on economic performance. It should be noted that New Zealand's economic underperformance began in the 1960s and so cannot be attributed to reforms since the 1980s, which almost certainly prevented more serious underperformance.

4 See Heritage Foundation (2014) and Gwartney et al. (2014), respectively.

Figure 1: GDP per capita, PPP (current international dollars)

Source: World Bank, <http://data.worldbank.org/indicator/NY.GDS.TOTL.ZS>.

It is difficult to estimate empirically the specific impacts of the absence of a comprehensive CGT on New Zealand's economic performance given these other factors. There is also a lack of significant changes in capital gains tax rates that could be exploited to estimate their effects. In Australia, the introduction in 1999 of a CGT discount of 50 percent for individuals and 33 percent for managed funds, but not for companies, was associated with marked changes in their relative shares of realized capital gains. The share of overall gains reported by companies fell from around 35 percent to 20 percent over the subsequent decade, while the share reported by individuals increased from just under 20 percent to 30 percent (Clark, 2014: 40). There was an increase in overall capital gains tax realizations and revenue and record levels of business investment as a share of GDP (Kirchner, 2011). Even in the Australian case, however, it is difficult to come to definitive judgements about the effects of the change. It is nonetheless instructive to consider the performance of New Zealand on key metrics related to capital gains taxation compared to comparable economies.

New Zealand underperforms comparable countries in terms of saving rates. While long-term average gross national saving is higher than in the US or the UK, net national saving and the household saving rate are on average

lower than in comparable countries (table 1). Note that these averages make no allowance for changes in taxes. For example, Australia had major changes in capital gains tax in 1985 and 1999, resulting in three capital gains tax regimes over the sample period shown in the table.

Table 1: Long-term average saving rates for selected OECD countries

Country	Gross national saving rate		Net national saving rate		Household saving rate	
	%GDP	Years	%GDP	Years	%GDP	Years
Korea	31.2	1972-2006	20.3	1972-2006	10.2	1990-2010
Japan	30.7	1972-2008	13.6	1972-2008	6.4	1996-2009
Norway	29.4	1972-2006	14.2	1972-2006	3.9	1978-2010
Finland	24.5	1975-2009	8.4	1975-2009	1.5	1996-2010
Sweden	24.5	1972-2006	12.6	1972-2006	7.1	1995-2010
Australia	23.4	1972-2010	7.6	1972-2010	8.5	1972-2008
Germany	22.7	1972-2010	8.8	1972-2010	10.6	1994-2010
Canada	20.5	1972-2010	8.0	1972-2010	10.2	1972-2010
Ireland	17.9	1972-2010	7.1	1972-2010	2.6	2002-2010
New Zealand	17.7	1972-2012	3.4	1972-2012	-0.1	1972-2012
United Kingdom	16.7	1972-2010	4.5	1972-2010	1.0	1995-2009
United States	16.5	1972-2010	5.1	1972-2010	6.8	1972-2010

Note: Countries ranked by ratio of gross national saving to GDP.

Source: Adapted from Gorman, Scobie, and Paek (2013: 22). Years shown for Finland have been changed to correct for what is assumed to be a typographical error in the original table.

New Zealand's saving performance is considered by many to be a significant issue for public policy (SWG, 2011). However, measured saving rates in New Zealand are likely to be understated compared to other countries. Inflation redistributes wealth to borrowers. Given that New Zealand is a significant borrower internationally, with a relatively large current account deficit, the inflation distortion to measured saving rates is likely to be larger than for other countries. There are other measurement and classification issues that are also likely to understate New Zealand's rate of saving. New Zealand's Treasury has estimated that adjusting for these factors could increase measured saving from 1.4 percent to 11.2 percent of GDP in the year 2011 (Gorman,

Scobie, and Paek, 2013: 34). The evidence base for the proposition that New Zealand saves too little is weaker than many suppose.

The view that New Zealand undersaves can lead to perverse public policy recommendations. For example, the Savings Working Group (2011) suggested that net inward migration contributed to New Zealand's saving problem. But as noted above, New Zealand's lack of scale is likely implicated in New Zealand's economic underperformance. A more restrictive approach to immigration would likely exacerbate the problems of small scale and reduce saving and investment in absolute if not relative terms.

In terms of investment as a share of GDP, gross capital formation averaged 22.7 percent of GDP in New Zealand between 1960 and 2012, compared to 21.8 percent in Canada and 27.8 percent in Australia.⁵ Decomposing growth in Australia and New Zealand into capital and labour inputs and productivity growth over the period 1996–2012 shows that New Zealand outperforms in terms of capital and multifactor productivity, but lags in labour productivity due to a slower rate of capital deepening (table 2).

**Table 2: Average annual productivity growth rates (%),
Australia and New Zealand, 1996–2012**

	Australia	New Zealand
Output	3.5	2.5
Labour productivity	2.1	1.4
Capital productivity	-1.7	-0.6
Multifactor productivity	0.5	0.6
Labour input	1.4	1.1
Capital input	5.4	3.1
Total inputs	3.0	1.9
Capital-to-labour-ratio	3.9	2.0

Note: The above figures for New Zealand cover the “measured” sector that excludes some sectors where growth in outputs is hard to measure. Comparisons of multifactor productivity based on OECD and Conference Board data are less favourable to New Zealand. The author would like to thank Michael Reddell for this observation..

Source: Statistics New Zealand, 2013b.

5 World Bank data from <<http://data.worldbank.org/indicator/NE.GDI.FTOT.ZS>>.

New Zealand would appear to underperform comparable economies in terms of measured saving and investment rates, although measurement issues inevitably complicate such cross-country comparisons. The question for public policy is whether the introduction of a comprehensive CGT, either in isolation or as part of a broader tax reform effort, would help or hinder New Zealand's saving, investment, and broader economic performance. While New Zealand's saving and investment performance is considered by some to be a significant public policy problem, policymakers have consistently ruled out the introduction of a comprehensive CGT as a solution. For example, the 2011 Savings Working Group was precluded from considering the issue as part of its terms of reference (SWG, 2011).

Conclusion

New Zealand is internationally anomalous in not having a comprehensive CGT. However, some capital gains are taxed depending on the nature of the transaction and the type and purposes of the taxpayer. This apparent anomaly is readily explicable when considered in the context of a small open economy subject to highly mobile capital and labour, including mostly free labour and capital flows between Australia and New Zealand. The absence of a comprehensive CGT is also explicable in terms of the theory of optimal tax systems, which recognises that idealised tax systems are unlikely to survive an encounter with the real world in which tax compliance and collection technologies and the political process act as constraints.

A comprehensive CGT still has many advocates and supporters, including within official circles in New Zealand. However, whenever the introduction of a comprehensive CGT has been seriously considered in the context of official reviews of the tax system, the option has not been pursued for both practical and political reasons. Instead, the tax reform process that commenced in the early 1980s has focused on taxing consumption through a relatively efficient, broad-base, single-rate goods and services tax while seeking to alleviate the tax burden on capital. This approach has proven to be more politically robust and has left New Zealand with a relatively efficient tax system by international standards, although somewhat less efficient today than at the end of the 1980s.

New Zealand's hybrid approach to taxing the returns from capital does create some anomalies and complexity, as well as incentives and opportunities for avoidance. However, a comprehensive CGT could be expected to introduce problems of its own, while many of the existing problems in the tax system could be more effectively minimised through a focus on lowering other tax rates in order to render expensive tax planning uneconomic.

Capital gains taxes are often supported as an equity measure based on an expectation that the burden of CGT will largely fall on high income earners with significant assets. However, the tax system is an inefficient and costly way of pursuing equity objectives. These are best realized on the expenditure side of the budget, where New Zealand already carries out significant income redistribution. The focus of the tax system should be on raising revenue at the lowest efficiency cost, and taxing systematic gains rather than the returns to risk-bearing.

New Zealand's tax system does create a bias in favour of saving via owner-occupied and buy-to-let property, but is hardly exceptional in this regard. As in other countries, this bias is not so much a case of saving via housing being taxed too lightly, but of other forms of saving and investment being taxed too heavily. Rather than expanding the scope of capital taxation to include housing assets, a better approach would be to reduce the tax burden on other assets to alleviate the double taxation of saving that occurs through the existing tax system. The introduction of a CGT that exempted owner-occupied housing would only increase the bias in favour of saving via owner-occupied housing.

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About the author

Stephen Kirchner

Stephen Kirchner is an economist with the Australian Financial Markets Association and a senior fellow with the Fraser Institute. Previously, he was a research fellow at Australia's Centre for Independent Studies. He has been a senior lecturer in economics at the University of Technology Sydney Business School and an economist with Action Economics, LLC, and Standard & Poor's Institutional Market Services based in Sydney and Singapore. He has also worked as an advisor to members of the Australian House of Representatives and Senate. Kirchner holds a BA (Hons) from the Australian National University, a Master of Economics (Hons) from Macquarie University, and a PhD in Economics from the University of New South Wales. He blogs at www.institutional-economics.com and is active on Twitter (@insteconomics).

Dr. Kirchner would like to thank Robin Oliver, Michael Reddell, Bryce Wilkinson, and Greg Dwyer for comments on earlier drafts.

Zero Capital Gains Taxes in Hong Kong: Preserving Simplicity and Reducing Cyclicity

Bill Stacey

The structure of Hong Kong taxes and principles

Hong Kong does not have a capital gains tax regime. The government has reviewed options for broadening the tax base and rejected a capital gains tax as complex and inconsistent with the principles of its low tax policy. Whilst this seems unusual in comparison to many countries internationally, it is in principle consistent with the British common law traditions of taxation which have been applied in Hong Kong since colonial rule.

The result is a system of taxation that has low compliance costs and low incentives for evasion, a system which has helped to attract trade and deepen financial markets in Hong Kong.

Hong Kong's public finance officials (Treasury Branch, 2014) list the principles of the tax regime as:

- Low and simple tax regime
- Territorial source principle
- Schedular tax (that is, tax is only levied on scheduled income)
- Neutrality
- Transparent and predictable

These principles show some of the reasons why Hong Kong has not adopted taxes on capital gains. It would add complexity. The territorial focus of the system would exclude capital gains on assets outside Hong Kong, making the potential tax base relatively narrow. The focus on taxing only specified

(scheduled) sources of income means that there is no presumption that tax should be applied to all income.

However, despite the absence of a specific capital gains tax, many capital transactions do generate substantial revenues for the government. The companies and income tax regimes tax profits from trade in assets that are a part of the routine business of a company. The tax system that mirrors some of the essentials of a Georgist model imposes high land premiums on improvements to land and taxes on transfers.¹ This system effectively assesses many of the rents available from capital gains on property for the public purse.

The first section of this paper looks at the place of capital gains taxes in the debate about taxation in Hong Kong. The second section looks at the alternatives to a comprehensive capital gains tax regime that are applied in Hong Kong. The third section looks at the overall taxation of capital and the issue of diversion from taxed income to untaxed capital gains within the system. In a fourth section we look at the impact of the tax system on savings and investment decisions. We conclude by looking at the efficiency of the system and the importance of the low tax regime in maintaining efficiency and equity.

Debate about broadening the tax base and disadvantages of a capital gains tax

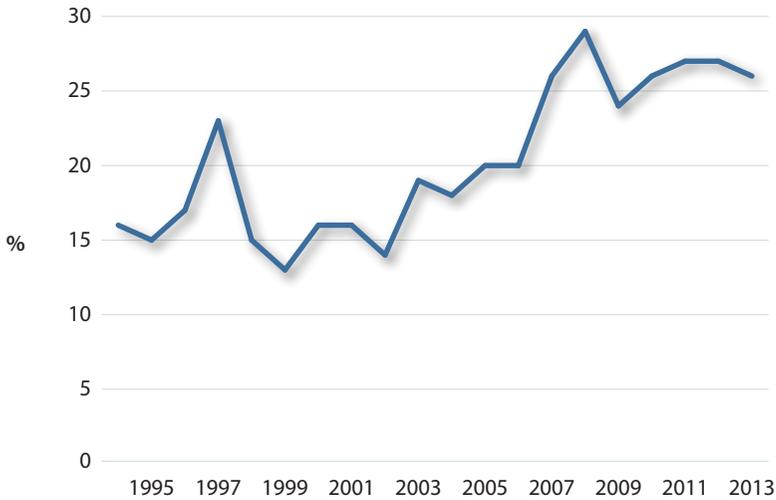
Hong Kong has had a vigorous debate about the structure of taxation in the SAR. The government has asserted that the tax base is too narrow and procyclical (Financial Services and Treasury Bureau, 2006: 1). This debate is central to understanding thinking about the taxation of capital gains in Hong Kong.

The last detailed government review of the structure of taxation in Hong Kong was undertaken in 2006/07. The review preceded the western financial crisis and was heavily informed by the experience of the Asia financial crisis and its aftermath, which impacted Hong Kong from 1997 to 2002. During this period, total annual government revenue dropped 37.5 percent

1 Henry George (1839–1897) was a proponent of taxation on the unimproved value of land as an alternative to taxing income or productive activity. His *Progress and Poverty: An Inquiry into the Cause of Industrial Depressions and of Increase of Want with Increase of Wealth: The Remedy* (1879) is the best known exposition of his ideas.

and direct tax revenue dropped 20.3 percent. Revenue did not match the peak revenue of the 1996/07 fiscal year until 2006/07 ([figure 1](#)).²

Figure 1: Government revenue / nominal GDP, 2014



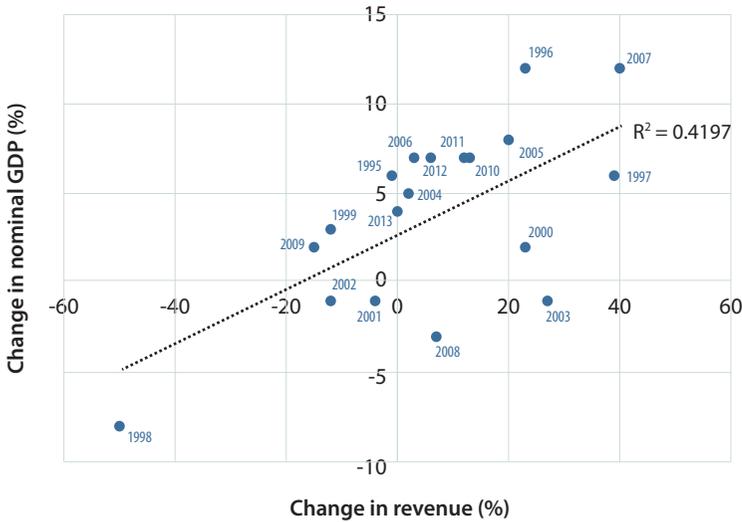
Source: Census and Statistics Department, 2013.

With demands on recurrent government spending for health and welfare as well as countercyclical policy measures increasing, more stable sources of revenue have been sought.

The evidence from the recent financial crisis should moderate those concerns. Total government revenues only dropped 11 percent from the year ended 30 June 2008 to a trough in the year ending 30 June 2009 and recovered in just two years after then. Moreover, the cyclicity of revenues largely reflects the cyclicity of the economy ([figure 2](#)).

² These figures use Total Government Revenue from Table 193 (Census and Statistics Department, 2013), which includes direct and indirect taxes as well as “capital” revenues from the sale of land.

Figure 2: Cyclicality of government revenues:
Change of revenue with nominal GDP



Source: Census and Statistics Department, 2013.

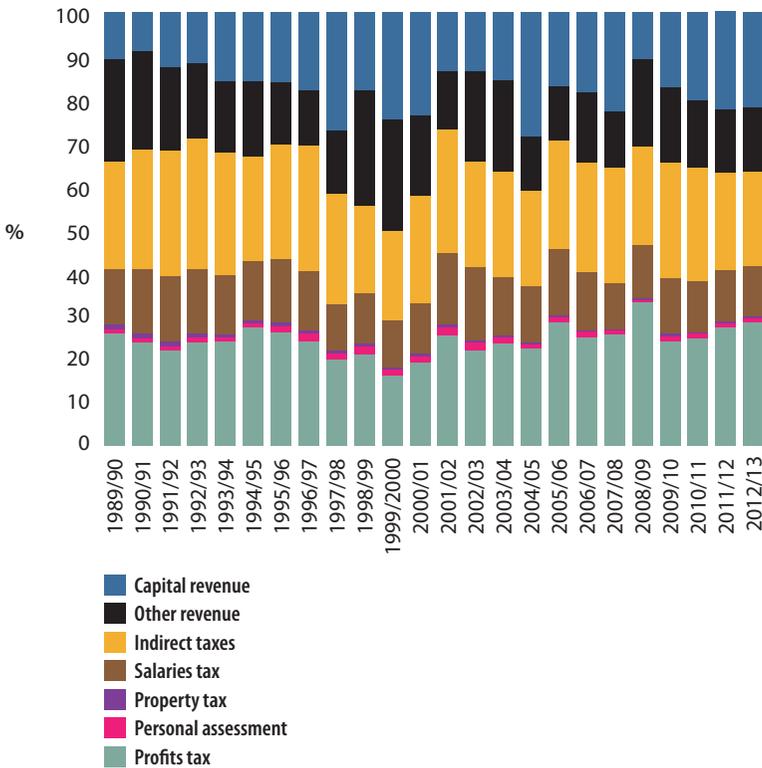
The mix of revenues has been relatively stable, with direct taxes averaging 39 percent of revenues, indirect taxes 25 percent, and “capital revenue” 17.9 percent. Capital revenue in the last decade has comprised 69 percent land premiums. In the same period, the combination of stamp duties and capital revenues have been 30 percent of government revenues (figure 3).

As we will discuss below, the introduction of a capital gains tax regime would be likely to have substitution effects between different taxes that are already levied in Hong Kong. Efforts to stabilize revenues through the cycle may seem desirable for budget planning, but are also likely to damage the ability of the economy to respond to global cycles.

The 2006/07 Public Consultation on Tax Reform Final Report commented favourably on aspects of capital gains tax:

Some people consider that a capital gains tax can help broaden the tax base and bring additional revenue to the Government. Besides, this tax is fair as it applies to capital gains only and would not widen the wealth gap. (Financial Services and Treasury Bureau, 2007: 17)

Figure 3: Hong Kong government revenue mix



Source: Census and Statistics Department, 2013.

Negative views reported in the consultation showed a longer list of concerns about the impacts:

However, some doubt whether the tax can bring stable revenue to the Government because capital value is easily affected by economic cycles. During economic downturns, capital value and related transactions would drop, and hence, the Government may not be able to raise stable revenue from this tax. In addition, some are concerned that the tax may prompt investors to invest offshore in order to avoid tax on their investment gains in Hong Kong. This would affect the status of Hong Kong as an international financial centre. (Financial Services and Treasury Bureau, 2007: 17)

The context for these comments is a process that was designed to conclude that Hong Kong should introduce a consumption tax. Consumption tax proposals were ultimately not pursued by the government, given strong public opposition, the recovery of government revenues generating surpluses, and recognition that consumption taxes in a very open economy like Hong Kong would also prove pro-cyclical and complex to implement and would impact international competitiveness.

However, the comments illustrate that the debate about capital gains tax in Hong Kong has been considered not from the perspective of equity, efficiency, or raising new revenue so much as the potential to stabilize revenues over time. The debate has assumed that there would be exemptions for some capital gains from taxation under any politically feasible approach, with residential property and assets outside Hong Kong the most likely areas of exemption. Given the close integration of the Hong Kong economy with that of China, the potential tax base of capital gains realized on Hong Kong assets could well be surprisingly narrow.

No previous estimates had been made of the potential revenue from a comprehensive capital gains tax in Hong Kong to inform the debate, but the narrow base, exclusions, and substitution effects were considered likely to be high. We make some high level estimates of the potential tax base in the following discussion.

The Hong Kong government is well aware of the constraints imposed by being a small and open economy, with a linked exchange rate that relies on a strong fiscal position and low debt for its stability. It is especially wary of proposals that would impact transaction costs in capital markets or the position of Hong Kong as a regional commercial centre.

Furthermore, with capital gains that are part of trading activities already taxed, there are more obvious places to look for tax equity and revenues. Arguably, incorporation offers many advantages over the personal tax system, opening a wide array of potential deductions and more narrowly taxing income on a territorial basis. The personal and profits tax system could be better aligned. Similarly, large existing revenues from land sales are subject to hypothecation rules limiting their use to capital works expenditures. If this measure ever had a useful purchase, the well-developed physical infrastructure and declining population growth suggest that this should now be reformed.

In summary, whilst capital gains tax has been a part of the debate about tax change in Hong Kong it has not been central to that debate. The debate has not produced sophisticated economic and revenue analysis of the potential impacts of a capital gains tax, but has gone far enough to suggest that the cost-benefit analysis would be unfavourable.

Alternative taxation of capital

Hong Kong has taxed capital transactions in a number of ways that are different to a traditional capital gains tax, but which are important for understanding the structure of the tax system. These include:

- ♦ Profits tax
- ♦ Taxation of share based remuneration
- ♦ Land premium on transfer or change of use
- ♦ Stamp duties
- ♦ Estate duties, which were abolished in 2005

The profits tax is applied to income generated “in the ordinary course of a trade, profession, or business”. This means that companies that have trading assets as their ordinary business will typically be subject to profits tax from those businesses at the 16.5% profits tax rate for corporations or 15% for unincorporated businesses. The issue of defining when sale of an asset is income or a capital transaction is becoming more developed in case law that parallels the principles in other common law jurisdictions. However, it remains a very poorly defined part of the tax law, which often gives rise to disputes. Sale of property and profits from the sale of many securities or, for example, taxi licenses (Board of Review, Inland Revenue Department, 2000) will often be captured by the profits tax when it is considered part of the ordinary operations of the company.

The principle applied to determining profits tax liability on a capital gain is the ill-defined idea of “intention at time of purchase.” If the intention of a purchase is a long-term capital or personal holding it might not be taxed, but if it is “an adventure in the nature of trade” to make profit from the purchase and subsequent sale it will be taxed. The grey lines provide opportunities

for careful planning and tax structuring to ensure no tax liability, which are important practice areas for tax advisors in Hong Kong, suggesting that the law should be clarified.³

Share based remuneration is taxable in Hong Kong. This prevents the conversion of salaried income, subject to tax, to possible capital gains that could be tax free. With many employees of global firms and a territorial principle of taxation, this presents problems for enforcement. Typically at issue is whether vesting shares are income relating to employment in Hong Kong or from other jurisdictions where employees may have been at the time of grant.

Land premium is payable in Hong Kong when land is sold by the government or when there is a change of use for land. There is also a system of rates and government rent levied on land as well as property tax on the income from property. Almost all land in Hong Kong is held on a lease from the government. Whilst the land premium levied on the sale of land is a purely capital transaction, the imposition of premium on change of use acts in some ways like a capital gains tax. Purchasers of land need to take into account the potential government levy that reflects the change in the value of the land from a new use. This is a disincentive for land sales, but also applies to existing holders of land and acts as a disincentive to improve property or change use to more efficient purposes. Land premium has averaged 13.8 percent of total government revenue in the past decade (Census and Statistics Department, 2013). Land premium revenue is quarantined by the government and can only be used for capital expenditure.

Stamp duties are levied on property and securities transactions, based on the transaction value. These duties averaged 10.3 percent of total revenues over the past decade. Whilst it is a transaction charge and not levied on capital gains, the stamp duty regime has been adapted by the government for “macro-prudential” purposes to discourage sales of apartments and in particular high value sales (Financial Services and Treasury Bureau, 2013). The changes have been heavily criticized for their technical incoherence, and legislation to implement the new scheme introduced in February 2013 only

3 The definition of income for profits tax is included in the Internal Revenue Ordinance Chapter 112, Section 14 (Hong Kong Legislative Council, no date). Recent cases before the Inland Revenue Board of Review turning on these issues include Case No. D18/13, 2013-14, Case No. D17/13, 2013-14, and Case No. D25/13, 2013-14.

passed the Hong Kong legislature in July 2014. However, the special stamp duties have garnered wide popular support. Stamp duties would be one taxation source that would have to be designed to interact with a capital gains tax. Stamp duties should be deductible and add to the purchase price base for capital gains tax purposes, reducing potential net revenues from the most common capital transactions.

Estate duties were applied to the capital value of an estate until abolition in 2005. The reasons for the abolition are instructive, as described by the Secretary for Financial Services at the time, Mr Frederic Ma:

By abolishing estate duty, we believe Hong Kong can attract more local and overseas investors to hold assets here. The abolition can further promote the development of Hong Kong as an important asset management centre. More companies and professionals will come here, and this will facilitate the further development of our asset management services, create more employment opportunities, and in turn make Hong Kong more competitive as an international financial centre. (Ma, 2005)

The foregone revenue was estimated by the government in the same release at HKD1.5bn per annum. A simple calculation assuming an average life span for Hong Kong residents of 80 years provides a rough estimate of HKD 1,200 bn for the assessable capital base in Hong Kong for a capital gains tax, since the estate duty was also assessed on a territorial basis. If we assume a 5 percent real return on capital and 16.5 percent rate, it suggests a potential annual capital gains revenue of HKD 13bn, which would be just 3 percent of total government revenues before exemptions are considered. This rough calculation suggests that a small (10 percent) behavioural change and decline in transaction volumes impacting stamp duty could offset any revenue gains from a comprehensive capital gains tax.

Whilst capital gains are not directly taxed in Hong Kong, one of the largest sources of capital gains, property, is very heavily taxed. Large parts of those taxes are levied in advance of economic gains rather than on realization, through a system of land premiums. The system of stamp duties, rates, and government rent is relatively stable, and the revenue base will grow over time as land values are revised upwards.

There is room for criticism of this tax regime. It discourages improvement of properties, reinforces the barriers to entry in the market for property development and redevelopment, and is increasingly being used by the government to introduce new distortions under the guise of macro-prudential controls.

By contrast with these existing taxes, the potential revenues from a comprehensive capital gains tax are modest.

Diversion between income and capital gains

Absence of a capital gains tax or a low rate for capital gains is cited as risking the diversion of income to capital gains, eroding the total tax base (Anrig, 2011).

Hsu and Yuen (2000), writing for a Fraser Institute symposium, found little evidence for this diversion in Hong Kong:

[W]e find in the case of Hong Kong that the evidence on tax avoidance in relation to the non-existent capital gains tax is meager and indirect. This leads us to the somewhat speculative conclusion that little (if any) inefficiency has resulted from the absence of the tax.

The finding still holds. Hong Kong lacks channels for such diversion of income and the efforts to maintain tax neutrality in the system provide slight incentive.

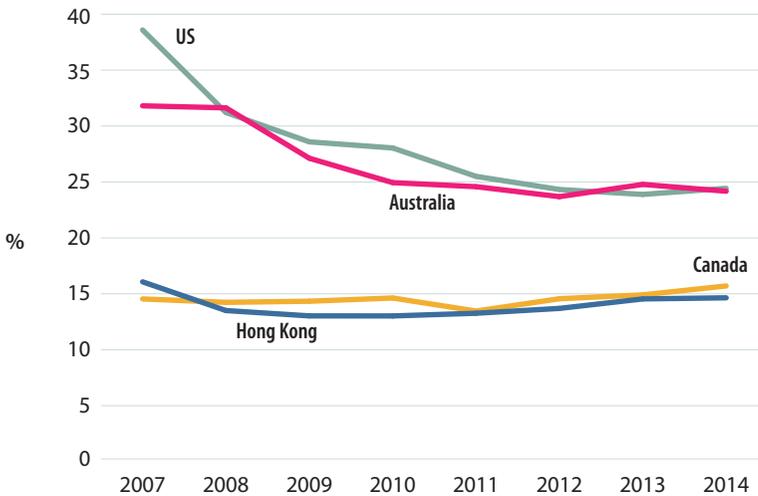
There is no tax on dividends in Hong Kong in the hands of companies or individuals. Aligned with this, interest income is not taxed either. Since Hong Kong does not tax interest income, it has since 2004 sought to somewhat limit profit tax deductions for interest expenses, particularly for activities outside Hong Kong or those producing interest income. Personal income tax rates and profit tax rates are very close. Ordinary course of business capital gains are taxed. So officers and shareholders have little incentive to prefer deferral of capital gains over realization. Realization of a capital asset not in the ordinary course of business will generate a tax free gain that can be reinvested in other assets at a tax free rate of return.

This creates a system that can be described as “superneutral” apart from the taxation of land improvements. The resulting system offers insights

about how distortions from tax regimes impact corporate behavior. With no tax on the realization of capital gains, one incentive for the use of leverage is reduced.

With dividend distributions not taxed and so no double taxation of corporate income, incentives to use buybacks to generate capital appreciation on shares rather than distributing the benefits form gains are also less. The result is that leverage ratios are lower in Hong Kong than other major economies and dividend yields are typically higher (figure 4).

Figure 4: Debt/asset ratio, listed equities

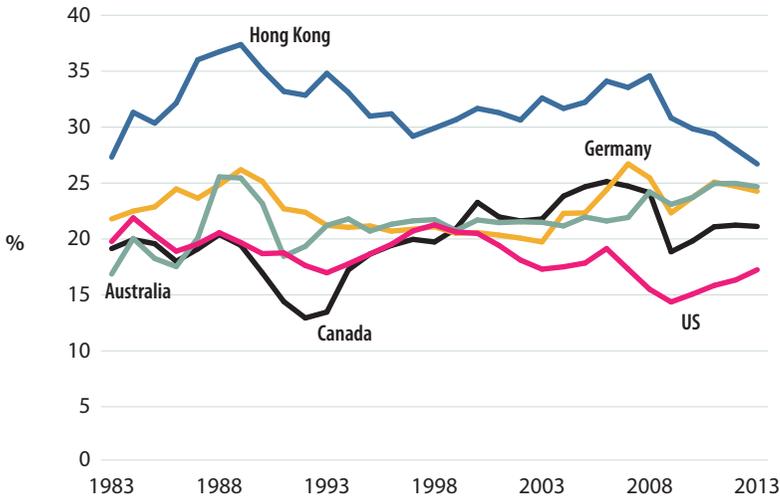


Source: Bloomberg, MSCI. For HK the MSCI index used focuses on companies incorporated in Hong Kong with a high mix of local activities.

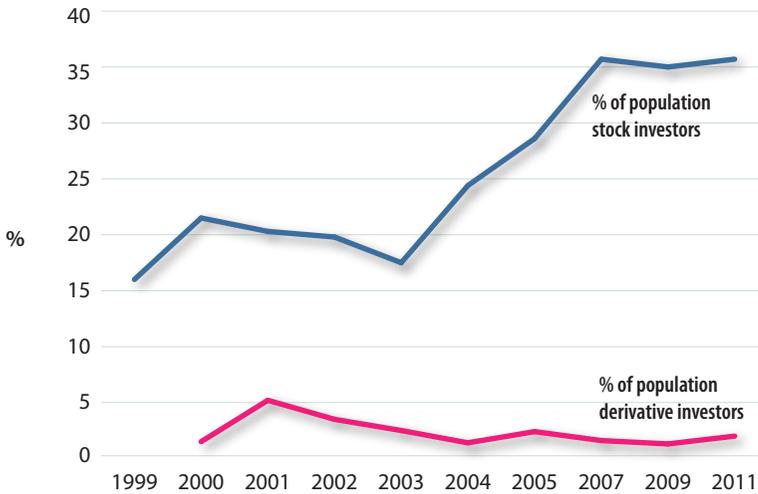
Savings, trading and investment decisions

The debate about changes to capital gains taxes, particularly in the US is often framed around the impact on incentives to save and invest. Hong Kong with a zero capital gains tax does indeed have a higher savings rate than similar developed economies (figure 5). Similarly Hong Kong has deep financial markets that are reliant on domestic sources of investment and funding to support capital raising and listing for China and international stocks. Half of all deposits are held in currencies other than the HKD. Retail investment in equities markets is high and easily accessible derivatives products were developed early. The maturity of the markets cannot exclusively be attributed to the lack of a capital gains tax, but the overall tax structure reduces transaction costs and its neutrality across investment types supports the unusual breadth of the market for a relatively small population.

Figure 5: Gross national savings / GDP



Source: IMF, Bloomberg.

Figure 6: Proportion of investors in population

Source: Hong Kong Stock Exchange.

Efficiency and the importance of a low tax regime

Capital gains taxation has been debated in other jurisdictions from the perspective of equity and incentives for saving and investment. In Hong Kong, the reasons for rejecting the tax have been more about tax neutrality, efficiency of administration, and the cyclical nature of likely modest potential revenues.

The simplicity and low rates of taxation in Hong Kong lead to high rates of compliance and lower costs of compliance. Low tax rates contribute to the limited diversion of revenue away from taxed income. As one indication, for one global accounting firm 25 percent of American revenues come from their tax practice (KPMG, 2013). In Asia that is 18 percent of revenues and in Hong Kong the number is closer to 10 percent, of which much is international tax work. Those lower costs generate welfare gains and add to efficiency.

Domestic tax-driven investment products are absent in Hong Kong. High tax complexity is regressive and arguably undermines equity by advantaging people able to hire costly tax advisers and engage in more complex structuring of their affairs. These advantages are absent in Hong Kong so whilst there is a debate about inequality and lower income growth for the

salaried population, inequality is rarely attributed to the tax system and changes to the tax regime are rarely seen as an answer to inequality.

Hong Kong tax policy has sought to reinforce the advantages of the city as a financial centre and location for regional corporate headquarters. It actively promotes the advantages of no taxes on capital gains. The policy commitment to this regime as a source of competitive advantage is strong. However, this is reinforced by the experience of efficiency gains within companies and the administration of taxation that arise from the simple system.

However, observers need to recognize that whilst there is no capital gains tax, there are relatively high transaction duties on capital transactions, and government land premiums play a central role in the property market in Hong Kong. Moreover, these levies on capital are being used more for “macro-prudential” goals that impose a cost on the efficiency of these markets. For all the merits of the Hong Kong tax regime, there remains scope to benefit from reform, particularly in the taxation of property.

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About the author

Bill Stacey

Bill Stacey is the Chairman of Hong Kong's leading free market think tank, the Lion Rock Institute. He is on the Board of the Mannkal Economic Education Foundation in Australia, and has been involved in advocacy of market reform for the last 25 years. Professionally, Bill has been an executive with leading financial institutions in Asia and globally. During the 1997 financial crisis in Asia and subsequently, he led restructuring initiatives, strategic assessments, and provided input to reform proposals. As a senior equity analyst with Credit Suisse, Bill led research on the three largest China financial sector IPOs and is a leading commentator on the financial systems in the region. He is currently the head of the Hong Kong operations of a macro focused securities company.

Capital Gains Taxation in Switzerland

Christoph A. Schaltegger and Marc M. Winistoerfer

Introduction

Currently, there is an ongoing public debate, whether Switzerland should implement a comprehensive capital gains tax as part of a well-designed tax system based on the principles of a comprehensive income tax. Some argue that Switzerland, being one of the few countries with a property tax on net wealth, basically taxes capital gains indirectly. Accordingly, the argument denies a loophole in the Swiss tax system. In fact, a proportional property tax of around 0.3 to 0.5 percent is levied by the cantons on the net worth of individuals. The tax is levied on the value of all assets (such as real estate, shares, or funds) after the deduction of any debts. Others have the opinion that a capital gains tax on the federal level should be part of the coming tax reforms to close an important loophole in the Swiss tax system of personal income. The latest example is the proposal of the government for a major redesign of the Swiss corporate income tax where preferential tax regimes for companies should be removed. In their concept, tax rates for corporate income should generally be reduced to realign the tax burden for all different corporate incomes. To finance the corresponding income loss, a capital gains tax is again debated publicly.

Another common argument is that Switzerland, as a small and open economy, is very much exposed to globalization. This implies that tax base elasticity should be taken into account when redesigning the tax system. A capital gains tax exhibits generally high elasticity since its tax base is very mobile. From this point of view, it is reasonable that Switzerland knows no comprehensive capital gains taxation.

This paper is organized as follows. We first provide an overview of the Swiss tax system reflecting the far-reaching federalism of the country, including the legal provisions and their historical records in the federal tax code as well as the cantonal tax codes concerning capital gains. Next, the political discussions on a federal tax on capital gains are summarized. Finally, we provide some economic considerations on the pros and cons of a comprehensive capital gains tax in Switzerland, followed by concluding remarks.

Capital gains taxation in Switzerland

In the following section, the legal background of the capital gains taxation in Switzerland is set in the context of the Swiss tax system. Therefore, some general remarks on Swiss fiscal federalism are required. Additionally, a summary of the capital gains tax law at the federal level as well as in the cantons will be given.

The Swiss tax system mirrors fiscal federalism in Switzerland

Switzerland is a highly decentralized country with three different political levels: the Confederation, the cantons and the communes. Because of Switzerland's federal structure, the taxing powers are divided between the three jurisdictions. Each level enjoys a certain degree of autonomy, resulting in a network of federal, cantonal, and communal taxes (Haller, 2009). Accordingly, the legal framework of the Swiss tax system is provided by both federal and cantonal legislation. The Swiss Federal Constitution of April 18, 1999 (BV) sets the general guidelines and principles, assigns the taxing powers between the different levels, and distributes the competences among the three levels.¹ The cantons retain the residual powers that are not exclusively assigned to Confederation, whereas the tasks of the Confederation are explicitly enumerated in Swiss constitutional law (Haller, 2009: 59 f). According to article 42 paragraph 1 BV, the federal level shall only accomplish the tasks that are attributed to it by the Federal Constitution.

1 Bundesverfassung der Schweizerischen Eidgenossenschaft vom 18. April 1999, SR 101, an unofficial English version of the Swiss Federal Constitution that has no legal force, is published at <http://www.admin.ch/opc/en/classified-compilation/19995395/index.html>.

The specific taxing powers of the Confederation are mentioned in the chapter of the Federal Constitution on the Financial System. Among the taxing powers that are exclusively assigned to the federal level are the value added tax, the special consumption taxes on different goods such as on tobacco and alcohol, the stamp duties and the withholding tax, and the customs duties (articles 130-133 BV).

Other taxes—e.g., the income tax—are not assigned exclusively to one level. The different jurisdictions share the power to levy this tax. Article 128 BV says that the Confederation may levy a direct tax of a maximum of 11.5 percent on the income of private individuals and of a maximum of 8.5 percent of the net profit of legal entities. The tax on income of private individuals and on net profit of legal entities was implemented by the Federal Act of December 14, 1990 on the Federal Direct Tax (DBG).² It entered into force on January 1, 1995. The Federal Direct Tax is assessed annually based on the actual net income of natural persons who are Swiss residents (articles 16-42 DBG) and on the net profits of the Swiss resident legal entities (articles 49-82 DBG). Additionally, non-resident natural persons and legal entities as well as foreign employees without a residence permit are subject to the tax at source (articles 83-101 DBG). Their tax liability is directly deducted from the gross income they earn in Switzerland.

The Federal Constitution declares in article 3 that the cantons are sovereign except to the extent that the constitution limits their sovereignty. They exercise all the rights that are not assigned to the Confederation. Unlike the Confederation, which needs a specific authorization in the Federal Constitution, the Swiss cantons do not need an enumeration of their competences. Within the scope of their powers the cantons decide on the tasks they intend to fulfill; the Confederation must respect the cantonal autonomy and leave the cantons with sufficient financial resources to fulfill their tasks (article 47 paragraph 2 BV). With regard to taxation, the cantons are basically authorized to levy any taxes as long as they do not infringe upon federal law, i.e., constitutional law (including the general principles of taxation), statutory, and regulatory law (Haller, 2009: 76 f).

According to article 127 BV, the main structural features of any tax, in particular the taxable person, the object of the tax, and its assessment, must be

2 Bundesgesetz über die direkte Bundessteuer vom 14. Dezember 1990, SR 642.11.

regulated by law. Provided the nature of the tax permits it, the principles of universality and uniformity of taxation as well as the principle of taxation according to ability to pay must be respected. In addition, the Confederation shall set out principles on the formal harmonization of the direct taxes imposed by the Confederation, the cantons and the communes. The harmonization of tax law shall extend to tax liability, the object of the tax and the tax period, procedural law, and the law relating to tax offences. Excluded from tax harmonization are, by contrast, the tax scales, the tax rates, and the tax allowances (article 129 BV).

Even though the competence of the federal level to formally harmonize the cantonal tax law had already been approved by popular vote in 1977, it took over a decade for the federal parliament to pass the Federal Tax Harmonization Act of December 14, 1990 (StHG).³ This formally harmonized the federal, cantonal, and communal tax law on direct taxation (Oberson and Hull, 2011). Since January 1, 1993, the cantons are required to tax the income and wealth of natural persons, and the profits and capital of legal entities; furthermore, they have to levy a tax at source on non-residents' income, and a special capital gains tax on real estate sales (article 2 paragraph 1 StHG).

Unlike the autonomy of the cantons, the Federal Constitution does not guarantee the autonomy of the communes (Haller, 2009: 48 f). The communal autonomy is guaranteed in accordance with cantonal law instead (article 50 paragraph 1 BV). With regard to taxation, the communes are endowed with more or less taxing power, depending on the respective canton. Within the limits of the cantonal law—and the Federal Tax Harmonization Act of December 14, 1990—the communes are free to legislate, i.e., set the tax rates and establish additional taxes on their territory. The communal tax revenues usually stem from indirect taxes and from a surcharge the communes levy on the cantonal income and wealth tax.

3 Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden vom 14. Dezember 1990, SR 642.14.

Capital gains taxes in Switzerland

In consequence of Swiss fiscal federalism the taxation of capital gains takes place at the federal level as well as in the cantons (and in the communes).

i. Federal tax law

In principle, all recurring and non-recurring income is liable to income taxation (article 16 paragraph 1 DBG). The income of corporations and cooperatives and the income of natural persons are subject to the Federal Direct Tax. Repeatedly, the Swiss Federal Supreme Court has confirmed that the taxable income includes the entire income from gainful employment, property income, and other revenue of the taxpayer.⁴ This definition includes the income from capital gains, i.e., the difference between the earnings from the sale of assets and the costs of investments.

a. Taxable capital gains realized by legal entities

With regard to the taxation of capital gains, it is important to distinguish between capital gains realized by natural persons and those realized by legal entities: corporations, corporations with unlimited partnership, limited liability companies, cooperatives, societies, and investment trusts with direct ownership of immovable property. The latter are subject to corporate income tax on the net profit which includes the annual gross income reduced by commercially justifiable expenses such as wages and interest costs, depreciation, provisions, replacements, and the net loss carry-forward of the previous seven years (articles 59-67 DBG). In accordance with the article 58 paragraph 1 litera c DBG, the taxable net profit of a legal entity includes inter alia the capital gains on its movable and immovable assets (Oberson and Hull, 2011: 10 ff). The capital gains, which form part of the net profit, are charged with a statutory tax rate of 8.5 percent for joint-stock companies, corporations with unlimited partnership, limited liability companies, and cooperatives (article 68 DBG); the net profit of all other legal entities are charged with a statutory tax rate of 4.25 percent (articles 71 and 72 DBG).

According to article 69 DBG, holding companies—joint-stock companies and cooperatives as well as foreign companies of a similar nature—may

4 E.g., Decision of the Federal Supreme Court (BGE) 125 II, p. 119, consideration 4.a; BGE 139 II, p. 365, consideration 2.1.

qualify for a tax relief. The tax relief applies to capital gains on substantial participations, namely if the participation represents at least 10 percent of the share capital of another company and has been held for at least one year (Oberson and Hull, 2011: 54 ff). Further exemptions from tax duty are enumerated in the article 56 DBG.

b. Tax-free capital gains realized by natural persons

Concerning the tax liability of capital gains realized by natural persons, the federal tax legislation distinguishes between capital gains on the sale of privately held assets on the one hand, the so-called private capital gains, and capital gains on the sale of business property on the other hand. This differentiation is important because the capital gains are taxed differently, depending on whether they belong to one or another. According to article 16 paragraph 3 DBG, the capital gains on the sale of private property—the relinquishment of ownership by the seller and the acquisition of the ownership by the purchaser—are tax-free.⁵ At the same time, capital losses on private property are not deductible from the income tax.

c. Taxable capital gains realized by natural persons

By contrast, the capital gains on the sale of business property realized by natural persons are liable to Federal Direct Tax (Oberson and Hull, 2011: 9). These capital gains belong to the taxable income which includes inter alia the capital gains on the sale, exchange, and re-evaluation of business property; equivalent to the sale, exchange and re-evaluation are the conversion of business assets into private property or the transfer of business assets to a foreign company (article 18 paragraph 2 DBG). It mainly concerns private individuals who actively manage their personal wealth and therefore systematically purchase and sell their investments. The capital gains that these private individuals realize on the sale of their investments are, under certain circumstances, treated as taxable income from independent business activity, i.e., self-employment income.

d. Relevant criteria for taxation

Since there is no legal definition of the term self-employment in the Federal Act of 14 December 1990 on the Federal Direct Tax, the Swiss Federal

⁵ See BGE 139 II, p. 367, consideration 2.3.

Supreme Court established the criteria that must be fulfilled. Accordingly, self-employment refers to any independent business activity in which somebody systematically uses labour and capital as factors of production with the intention of making profit, decides freely on the organization of the business, and bears the entrepreneurial risks, no matter if the activity is full-time or part-time, on a permanent or on a temporary basis.⁶ If someone systematically and regularly purchases and sells assets, intending to make profit, the investments are considered an independent business activity.⁷

The leading Federal Supreme Court case dates back to the year 1999. To determine if capital gains are taxable income, the Federal Supreme Court relied on different aspects such as the systematic way of proceeding, the frequency and the number of transactions, the profession of the taxpayer (i.e., if the taxpayer has special knowledge), and the use of borrowed capital.⁸

In another ruling, the Federal Supreme Court stated that all the facts of the individual case must be taken into account, and even if one or more of the defining elements are missing a business activity may be considered as self-employment.⁹ Because missing elements can be compensated by other elements it is nearly impossible to derive general principles from the rulings of the supreme judicial authority in Switzerland. Nevertheless, there seems to be one rule of thumb: tax authorities usually rule out taxing small private capital gains as long as they are not realized periodically. Capital gains that are realized by private individuals in the ordinary course of personal wealth management—that is, purchases and sales of assets that occur neither as part of a gainful activity nor on a regular basis—are exempt from income taxation.¹⁰

Moreover, only the capital gains realized on business property are subject to income taxation. Whether the assets are considered private property or business property depends on their current function.¹¹ According to article 18 paragraph 2 DBG, business property includes all assets that entirely or primarily serve to promote a self-employment purpose; in case this requirement is

6 See BGE 125 II, pp. 120 f., consideration 5.b; see Yersin (1999): 106.

7 See Oberson and Hull (2011): 51; see Eidgenössische Steuerverwaltung ESTV (2012).

8 BGE 125 II, p. 124, consideration 6.a; see the unpublished decisions of the Swiss Supreme Court No. 2C_766/2010 and No. 2C_385/2011.

9 E.g. BGE 122 II, p. 453, consideration 5.

10 BGE 125 II, pp. 122, consideration 5.d.

11 See BGE 133 II, p. 422, consideration 3.2; see Oberson and Hull, 2011: 50.

missing, the asset belongs to somebody's private property. The terms business property and private property, which are not defined by the Federal Act of December 14, 1990 on the Federal Direct Tax, are complementary, such that an asset can alternatively belong to one or another. When an asset is partly used for private purpose and partly for business purpose, it is fully assigned to somebody's private property or business property depending on its primary function.¹² In the above-mentioned leading case, the Swiss Federal Supreme Court considered that assets which serve the retirement provision of the owner do not automatically belong to his private property and, thus, the capital gains on these assets are not tax free.¹³ Whether an asset serves entirely or primarily to promote a self-employment purpose depends on its features, its actual utilization, the source of the funds that are necessary to finance the asset, and the motive for its acquisition (Arnold, 2006: 274 f). Another piece of evidence is the fact that an asset is reported on the balance sheet or that a capital depreciation has been made on the asset, which the law only permits for business assets.¹⁴

ii. Cantonal tax law

As the legislators intended the Swiss-wide harmonization of the legal terms and principles in tax law, the legal provisions of the Federal Tax Harmonization Act of December 14, 1990 and those of the Federal Act of December 14, 1990 on the Federal Direct Tax are very similar.¹⁵ In addition, the jurisdiction of the Swiss Federal Supreme Court established for capital gains under the Federal Direct Tax applies to cantonal income tax, too. Therefore, the cantonal tax laws concerning the taxation of capital gains comply widely with the federal law. As a result, the exemption from income taxation of capital gains on the sale of privately held property applies to the cantons, too.

a. Capital gains on the sale of immovable private property

Nevertheless, there is important difference between the federal and the cantonal taxation of capital gains: according to article 7 paragraph 4 litera b StHG, only the capital gains on the sale of movable assets realized by private individuals

12 See BGE 133 II, p. 423, consideration 3.3; see Yersin, 1999: 116.

13 See BGE 125 II, p. 125, consideration 6.b.

14 BGE 133 II, p. 422, consideration 3.2.

15 See BBl 1983 III, p. 4.

are exempt from cantonal income tax. By contrast, capital gains on the sale of immovable privately held property, i.e., real estate, are not exempt from cantonal (income) tax. The cantons are required to tax these real estate capital gains.

The capital gains on the sale of immovable private property and agricultural and forestry land are subject to special real estate capital gains tax, to the extent the proceeds exceed the investment costs (article 12 paragraph 1 StHG). Equivalent to the sale are inter alia legal transactions with a similar effect on behalf of the ownership or the conversion of privately held assets into business property (article 12 paragraph 2 StHG). In certain cases (e.g., when the property is acquired through inheritance) the taxation is postponed (article 12 paragraph 3 StHG).

b. Different cantonal tax systems

The specific tax systems vary from canton to canton. For example, the Canton of Geneva levies both the income tax and the special capital gains tax on real estate sales and allows the deduction of the latter from the income tax in order to avoid double taxation, while the Canton of Neuchâtel adds the capital gains on real estate sales to the other income and levies the ordinary income tax on the entire income. Other cantons (e.g., the Canton of Zug and the Canton of St. Gallen) levy the special tax if a taxpayer is not liable to the ordinary cantonal income tax even though the capital gains on real estate sales are normally subject to the ordinary income tax.

As long as the cantons do not infringe federal law, i.e., the Federal Tax Harmonization Act, they are free to determine the specific tax system and set the tax rates independently. The statutory tax rates of the special real estate capital gains tax depend in most of the cantons mainly on two aspects: the holding duration and the size of the realized capital gain. Almost half of the Swiss cantons apply a flat rate; the others apply a progressive tax rate depending on the size of the realized gain. In most cantons, the tax burden declines with the holding duration: the longer the immovable property had been held before it was sold, the lower the applicable statutory tax rate. According to § 109 Cantonal Tax Code (StG),¹⁶ the statutory tax rate in the Canton of Aargau declines from initially 40 percent to 5 percent after 25 years of ownership (table 1).

16 Steuergesetz des Kantons Aargau, SAR 651.100.

**Table 1: Example of tax burden change with duration of ownership
(Canton of Aargau)**

Duration of ownership	< 1 year	< 2 year	< 3 year	< 4 year	< 5 year	...	< 22 years	< 23 years	< 24 years	< 25 years	≥ 25 years
Statutory tax rate	40%	38%	36%	34%	32%	...	9%	8%	7%	6%	5%

In addition, the majority of cantons (e.g., the Cantons of Berne and Zurich) relieve small capital gains that do not reach a certain threshold from taxation. In spite of the Federal Tax Harmonization Act, there are substantial cantonal differences concerning the taxation of capital gains on real estate sales. Since the cantons allow different tax deductions, the actual tax burden may substantially deviate from the statutory tax rate.¹⁷

c. Capital gains on the sale of immovable business property

The capital gains on the sale of immovable business assets are, under certain circumstances, subject to the special real estate capital gains tax. The Federal Tax Harmonization Act allows the cantons to tax the sale of immovable business assets if these capital gains are exempt from corporate income tax, or if the corporate income tax is deductible from the special real estate capital gains tax (article 12 paragraph 4 StHG). Otherwise, the (corporate) income tax is levied on these capital gains. Therefore, in some cantons (e.g., the Canton of Lucerne) the capital gains realized on immovable business property are subject to ordinary (corporate) income tax, whereas the capital gains realized on privately held assets are subject to the special real estate capital gains tax (so-called dualistic system); in other cantons (e.g., the Canton of Zurich) the capital gains realized on immovable business property are subject to special capital gains tax on real estate sales, too (so-called monistic system).

17 See Schweizerische Steuerkonferenz SSK, 2012.

Current political discussions and propositions

The taxing powers of the Swiss Confederation have developed since the foundation of the federal state in 1848.¹⁸ In the course of these events the taxation of capital gains has been discussed repeatedly.

Past experience with capital gains taxation

From the founding of the Swiss Confederation in 1848 to the beginning of World War I, no income tax had been established at the federal level. In order to finance military expenditures, the public approved the non-recurrent Federal War Tax in the popular vote of June 6, 1915 (Schneider, 1925: 14 ff). The Federal War Tax was levied on the wealth and labour income of natural persons and on the capital of legal entities, whereas capital income was not subject to taxation. However, capital gains realized by industry, trade, and commerce were taxed with the recurrent Federal War Profit Tax, which expired in 1921. Based on the Federal Council Decree of September 18, 1916 on the Federal War Profit Tax,¹⁹ only corporate income was taxable.

A recurrent Federal War Tax was adopted on May 4, 1919. Based on the Federal Decree of September 28, 1920 on the Federal War Tax,²⁰ the tax was levied in four-year intervals. It allowed the Swiss Confederation to collect taxes on the wealth and labour income of natural persons, and on capital and net profit of legal entities, respectively. The proponents as well as the opponents of a permanent federal income tax supported the introduction of the Federal War Tax. The latter thought that this step would prevent the implementation of a permanent federal income tax because the recurrent Federal War Tax was to be abolished when the costs of World War I had been paid off (Schneider, 1925: 21). The recurrent Federal War Tax expired in 1932.

The Federal Crisis Tax on the entire income of natural persons and the net profit of joint-stock companies and cooperatives was imposed two years later in order to finance federal expenditures due to the Great Depression. Based on the Federal Council Decree of January 19, 1934 on the Federal Crisis

18 See Schaltegger and Weder, 2010.

19 Bundesbeschluss betreffend die eidgenössische Kriegsgewinnsteuer vom 18. September 1916.

20 Bundesbeschluss betreffend die neue ausserordentliche Kriegsteuer vom 28. September 1920.

Tax,²¹ capital gains realized by natural persons were subject to the income tax only if the respective individuals were legally obliged to keep books of account. However, capital gains realized by legal entities were taxed in every case.

On April 11, 1940, the new Federal Warfare Tax on the income and private property of natural persons and on the capital and net profits of legal entities was adopted. Although its legal basis, the Federal Council Decree of December, 9 1940 on the Federal Direct Tax (BdBSt),²² has been revised repeatedly, the Federal Direct Tax has remained in effect since then. Natural persons were subject to income tax only if the respective individuals were legally obliged to keep books of account (article 21 BdBSt). By contrast, capital gains realized by legal entities (i.e., corporations and cooperatives) were always subject to corporate income tax (article 49 BdBSt). When the Federal Tax Harmonization Act of 14 December 1990 was passed, only a few cantons (e.g., the Canton of Solothurn or the Canton of Basel-Stadt) levied a comprehensive capital gains tax, taxing capital gains realized on private property as well as on business assets.

Political discussion at the federal level

Before the Federal Tax Harmonization Act was introduced, the federal government had been asked to amend a provision to the draft, saying that capital gains on the sale of privately held assets would be subject to income tax.²³

Although the federal government rejected this proposal for practical reasons, the draft of the Federal Tax Harmonization Act, which entered into parliamentary deliberation, contained a provision according to which the cantons and communes could levy a special capital gains tax.²⁴ Hence, capital gains realized on privately held participation representing at least 20 percent of the share capital would have been subject to federal taxation. At that time, there was a growing public furor over some cases in which financiers had transferred their stakes for the initial price to an intermediary instead of selling them directly to the investor, in order to avoid paying taxes. In return,

21 Bundesratsbeschluss über die eidgenössische Krisenabgabe vom 19. January 1934.

22 Bundesratsbeschluss über die Erhebung einer direkten Bundessteuer vom 9. Dezember 1940.

23 See Postulate of the Members of the National Council Biel et al., No. 78.312.

24 See BBl 1983 III, pp. 38 ff.

the intermediary sold the shares to the investor such that the realized capital gains were tax free.²⁵ The federal government wanted to limit this practice.

Even though some parliamentarians were concerned that the absence of a capital gains tax would allow investors to avoid taxation, the majority of the federal parliament voted against the introduction of the capital gains tax because in most of the cantons it had been abolished and the cantons did not want to reintroduce it. Moreover, the additional tax revenue of the capital gains tax was considered too low to justify this step.²⁶ In addition, during the consultation procedure, in which the cantons, the political parties and other interest groups are usually invited to express their views when preparing important legislation, the proposed special capital gains tax had been strongly opposed, especially by the interest groups who would potentially have borne the main tax burden.

A minor legal adjustment occurred when the Federal Act of December 14, 1990 on the Federal Direct Tax was introduced. The legal provision that capital gains realized by natural persons were subject to the income tax only if the respective individuals were legally required to keep books of account was dropped.²⁷

In 1999, the Swiss Federation of Trade Unions (SFTU) requested an amendment to the Federal Constitution. With its popular initiative,²⁸ the SFTU proposed the introduction of a capital gains tax. The Swiss Confederation would levy a special federal tax on capital gains realized on movable property that hitherto had been exempt from Federal Direct Tax. According to the proposed popular initiative, the capital gains would have been taxed at a proportional rate of at least 20 percent, with a loss carry-forward of the previous two years and tax relief for small capital gains.²⁹

The SFTU argued that, unlike Switzerland, most European countries levied a tax on private capital gains. The exemption of private capital gains would lead to injustice. According to the initiators, it was not acceptable that labour income was fully taxed, while private capital gains were exempt from

25 See Official Bulletin of the Council of States 1986, pp. 123 f.

26 See Official Bulletin of the Council of States 1986, pp. 122 ff.; see Official Bulletin of the National Council 1989, pp. 22 ff.

27 BBl 1983 III, pp. 162 f.

28 Eidgenössische Volksinitiative «für eine Kapitalgewinnsteuer».

29 BBl 2000, pp. 2880 ff.

federal taxation. Furthermore, the SFTU estimated that the additional annual tax revenue of the capital gains tax would add up to one billion Swiss Francs, raising the annual tax revenue of the Confederation in 1998 by 2.9 percent from 34.7 to 35.7 Billion Swiss Francs.³⁰

The federal government rejected the amendment for various reasons: a special federal capital gains tax would collide with the cantonal wealth tax and lead to double taxation, cause inefficiently high administrative costs for both the taxpayers and the tax administration, and contribute little to total tax revenue. From the government's point of view, the imposition of a special capital gains tax at the federal level was therefore neither useful nor necessary.³¹ Nevertheless, the federal government announced that the introduction of a special capital gains tax would be discussed in the course of the Swiss Corporate Tax Reform II.³²

In both chambers of the federal parliament—the National Council and the Council of States—the majority of the representatives shared the point of view of the federal government, such that the amendment was rejected; the only major party that supported the amendment was the Social Democratic Party.³³ The mandatory referendum was held on December 2, 2001. The popular initiative failed to achieve the required majority. All cantons and almost two thirds of the popular vote rejected the proposed amendment.³⁴

When it came to the Swiss Corporate Tax Reform II, the federal government wanted to reduce the tax exemptions for capital gains. According to the federal government, the exemption of the so-called quasi-professional stock trading contradicted the principle of taxation according to ability to pay and, therefore, had to be revised.³⁵ However, the federal parliament objected to the extension of the tax liability that the federal government proposed because the majority could neither agree on amendments to the Federal Tax Harmonization Act of December 14, 1990 and to the Federal Act of December

30 See Schweizerischer Gewerkschaftsbund, 1998; the annual revenue of the Swiss Confederation is published at <<http://www.bfs.admin.ch/bfs/portal/de/index/infothek/lexikon/lex/0.topic.1.html>>.

31 BBl 2000, p. 6018.

32 BBl 2000, p. 6022.

33 See Official Bulletin of the National Council 2001, pp. 121 ff.; see Official Bulletin of the Council of States 2001, pp. 249 ff.

34 See BBl 2002, p. 1215.

35 See BBl 2005, pp. 4808 ff.

14, 1990 on the Federal Direct Tax, nor on a separate federal law concerning quasi-professional stock trading.³⁶ Eventually, the Swiss Corporate Tax Reform II brought a relief for dividends and capital gains.³⁷ This amendment was intended to reduce the incentive to shift retained earnings to capital gains instead of paying it out as dividend.³⁸

In the course of the Swiss Corporate Tax Reform III, which is currently in the consultation process, the tax exemptions of private capital gains—both at the federal level and in the cantons—will likely be revised.³⁹ The actual legal changes are not yet fully predictable. At the moment, it seems that the federal government intends to introduce a special capital gains tax, comparable to the special capital gains tax that was rejected by the parliament in the Eighties and at the beginning of the Swiss Corporate Tax Reform II.

Economic considerations

The tax system plays a central role in essentially all modern economies. Taxes account for 30 percent to 50 percent of GDP in most developed economies, with Switzerland lying somewhere on the lower end of that range. The way in which these public revenues are raised matters considerably for economic efficiency and for fairness. With the challenges of a globalized economy and an ageing society ahead, the importance of a well-designed tax system will most probably increase.

Normally, a benchmark for a good tax system is the well-known Haig-Simons concept of comprehensive income taxation (Simons, 1938). Comprehensive income taxation implies that the proper base of an income tax should be derived from an aggregation of all income regardless of the source. Hence, the tax design should follow the principle that there is no differentiation between capital and labour income or between the different forms of these income sources. Such a tax system treats similar economic activities in similar ways. In that sense the tax system is neutral and therefore will tend to

36 See Kommission für Wirtschaft und Abgaben des Ständerats, 2013; see Kommission für Wirtschaft und Abgaben des Nationalrats, 2014.

37 Schweizerische Steuerkonferenz SSK, 2009.

38 BBl 2005, pp. 4804 ff.

39 Eidgenössisches Finanzdepartement EFD, 2013.

be simpler, avoid unjustifiable discrimination between people and economic activities, and help to minimize economic distortions.

The famous Mirrlees Review (2011) summarizes the concept of comprehensive income taxation very clearly:

Income from all sources should be taxed according to the same rate schedule ... Applying different rates to different income sources complicates the system, unfairly favours those taxed more lightly, distorts economic activity towards lightly taxed forms, and facilitates tax avoidance. Taxing income from all sources equally does not just mean taxing fringe benefits in the same way as cash earnings. It also means applying that same rate schedule to, inter alia, self-employment income, property income, savings income, dividends, and capital gains.

The proposal of the Mirrlees Review for a systematic and expenditure-based taxation of capital income—in contrast to the aforementioned principles of comprehensive income taxation—follows along four lines, according to Keuschnigg (2011: 440). First, a normal return to savings and investment is tax free. A stepwise progressive income tax applies to above-normal returns such as economic rents. Firms are allowed to deduct not only interest on debt but also a normal, risk-free return on equity (allowance for corporate equity, ACE). Households can deduct a normal return on all forms of savings (rate-of-return allowance, RRA). Second, personal capital income taxation is complemented by a comprehensive lifetime wealth transfer tax levied on the recipient, including inheritances and inter vivos gifts and wealth transfers. Third, a separate, source-based corporate income tax is levied in addition to residence-based personal taxation of interest, dividends, and capital gains. The corporate tax rate is left unchanged. Fourth, tax rates are realigned to avoid tax arbitrage. In each income tax bracket, reduced rates apply to dividends and capital gains earned on corporate shareholdings, reflecting corporate tax already paid. At the margin, the same cumulative tax applies to different forms of income such as wages, earnings of the self-employed and sole proprietorships, and corporate income.

Thus, from the perspective of a tax system by design, capital gains should be part of the tax base and integrated in some way in a capital income tax to avoid distortions.

As in other countries, the Mirrlees Review also had a considerable impact on the debate among public economists in Switzerland. There is widespread agreement that a tax system inspired by the Mirrlees Review would have several implications for capital taxation in Switzerland. Most prominently, the allowance for corporate equity could reduce the marginal tax burden on capital to zero and considerably reduce the average tax burden for investments. Moreover, taxes on net wealth would not be part of the Mirrlees tax system in Switzerland. On the other hand, in the context of the personal income taxation, capital income had to be assessed more comprehensively, including capital gains, but with tax-free normal rates of return (Keuschnigg, 2011.)

Even though the comprehensive income tax as well as its principles on neutrality are widely accepted, the concept is not free of criticism. One argument is that neutrality is based exclusively on the argument of horizontal equity. All sources of income contribute equally to the tax base and the individual's ability to pay. However, this argument ignores the efficiency dimension of different taxes. Starting with the seminal contribution by Frank P. Ramsey (1927), the inverse-elasticity rule is basically an argument for taxing goods and services differently according to their tax base elasticity. Thus, capital gains should only be taxed equally to all other (capital) income if tax base elasticities are the same, which is not a realistic assumption for Switzerland as a small and open economy.

To sum up, capital gains taxation should be aligned to the tax burden of all forms of capital income in Switzerland if we accept comprehensive income taxation or the proposal of a more consumption-based tax system, as proposed by the Mirrlees review as the relevant benchmark to be approached. In this concept, the fact that Switzerland has no general capital gains tax on private property points to deficiencies and distortions in the tax design. The argument that Switzerland has a property tax on net wealth is only an inefficient compensation, which cannot properly correct for economic distortions.

On the other hand, if we use the inverse-elasticity rule, Switzerland should strengthen inelastic tax bases and reduce the tax burden on elastic tax bases. Capital gains are not part of inelastic tax bases, hence the adoption of

a general capital gains taxation would probably yield more economic distortions rather than fewer.

Conclusion

Capital gains taxation in Switzerland is one of the topics in fiscal policy that is regularly discussed. In principle, private capital gains have been and still are tax free in Switzerland. Several exceptions to this general rule exist, and together with a cantonal property tax on net wealth the tax burden on some forms of capital income is considerably high. Against this background, it is not surprising that some argue for a fundamental redesign of capital income taxation in Switzerland. A benchmark in that direction could be the Mirrlees tax system. Important elements are the allowance for corporate equity reducing the marginal tax burden on capital to zero and considerably reducing the average tax burden on investments. In addition, taxes on net wealth would have to be eliminated, which would require considerable changes in the balance of taxing power between the federal and the cantonal level. In the context of personal income taxation, capital income should be assessed comprehensively including capital gains but with tax-free normal rates of return.

On the other hand, some would argue that basically all tax systems deviate more or less from the basic principles of comprehensive income taxation. Hence, if we take the tax base elasticities into account, an increase in the tax burden on capital gains together with the property tax does not make the tax system more efficient as a whole. On the contrary, the mere adoption of a general capital gains taxation could probably increase economic distortions even more.

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About the authors

Christoph A. Schaltegger

Christoph A. Schaltegger is an economist, author, and academic who specialises in public finance and political economy issues. Professor Schaltegger is Director at the Swiss Institute of Public Finance and Fiscal Law IFF at the University of St. Gallen and a Professor of Political Economy in the department of economics at the University of Lucerne in Switzerland. He has been dean of the faculty of humanities and social sciences at the University of Lucerne since 2012. From 2008 to 2010, he was head of the fiscal affairs division and a member of the executive board of *economiesuisse* the Swiss business association in Zurich. From 2006 to 2008, he was personal adviser on tax policy to the Swiss minister of finance and an economic adviser for senior management on fiscal and tax policy at the Swiss Federal Tax Administration in Berne. Professor Schaltegger received a Habilitation (*venia legendi*) in economics at University of St. Gallen in 2009 and a PhD in economics from the University of Basel in 2003. Professor Schaltegger writes widely on economics for journals, newspapers and magazines in Switzerland and throughout Europe. He has also written a number of books. He can be reached at Christoph.Schaltegger@unilu.ch.

Marc Michael Winistoerfer

Marc Michael Winistoerfer served in the Swiss Armed Forces in 2004 and 2005 after graduating from high school. In 2008, he received a bachelor's degree (BLaw) and in 2010 a master's degree (MLaw) from the University of Lucerne. After an internship at the Swiss Federal Administration he began his studies in economics at the University of Berne in 2010. In 2011, he returned to the University of Lucerne where he continued studying economics and graduated in 2014 (BA in Political Economics). Since 2012, Mr. Winistoerfer has been working on his doctoral thesis in Swiss constitutional law. Since 2009 he has worked as a junior researcher, then researcher, at the University of Lucerne (chair of public law). His fields of research are Swiss constitutional law, public economic law, and institutional economics.

Economic and Tax Administration Issues Relating to Differential Tax Rates on Capital Gains

Stephen J. Entin

Many nations impose lower tax rates on capital gains than on ordinary income. Lower taxation of capital formation is generally beneficial to the economy and employment. However, a differential tax rate on capital gains can create definitional issues in calculating taxable income, and can provide opportunities for tax evasion that lead to tax compliance and enforcement problems. Are the economic benefits of lower tax rates on capital gains worth the enforcement and compliance costs? It appears that the economic benefits outweigh the costs by more than a hundred to one.

Is a capital gain income?

A capital gain or loss is the rise or fall in value of real property or a financial instrument as the price of the asset increases or decreases. Capital gains are not income in the economic sense.

Income in the economic sense is payment received for providing labor or capital services in the production of goods and services, constituting the factor payment side of GDP or national income. Income includes wages and salaries, rents, royalties, net interest, and profit (whether distributed to owners as dividends or retained for future reinvestment). Income equals output. The goods and services in output include consumption goods and services, investment goods (machines, buildings, infrastructure, etc.), and government

goods and services. (Gross economic income includes all investment. Net economic income subtracts investment that replaces older capital that is wearing out or becoming obsolete.)

The change in the price of an existing asset is not payment for new output. For example, the rise in the price of a Rembrandt from one sale to the next is not current output. The painting, valued at its first sales price, was part of Dutch GDP the year it was painted and first sold. The only contribution of the latest sale to current GDP is the commission of the auction house for the service of bringing buyer and seller together. A capital gain is an increase in the value that people place on an existing asset. It is not additional output.

It is important to distinguish between income, as measured by current economic production, and capital gains and losses, which are a change in wealth reflecting changes in future income, i.e., future production. In an efficient market, the current price of an asset is equal to the present discounted value of its expected future after-tax earnings. A rise in asset price occurs when there is an increase in expected future earnings. Counting both current production and capital gains and losses as current income involves double counting of the future production in both the current year and the year in which it will occur. This is why capital gains are not income in the economic sense, and why they do not appear as income in the National Income and Product Accounts, which measure current economic output and the payments received for producing it.

Taxing capital gains as ordinary income is double taxation. If the higher expected future earnings that create the gain ever materialize, they will be subject to tax in that future period. To also tax the increase in the present value of those after-tax future earnings is to subject them to double taxation. Some of the growth in value may be due to retained or reinvested earnings, but the phenomenon goes well beyond that. The gain in expected future earnings may arise from the invention of a better mousetrap or cure for cancer, a shift in consumer sentiment, a change in taxes, regulations, or inflation, or any number of additional causes.

The double tax inherent in the taxation of capital gains under an income tax, absent deferral of the saving, is the most compelling argument for having a tax rate differential. It could also furnish a test for determining whether a transaction should be regarded as a capital gain or loss. In theory, one could deny capital gains treatment for gains and losses associated with

contracts that are zero sum games, with no prospect of a valuation change due to changes in expected future net earnings.

Following the income tax levied during the US Civil War, the Supreme Court ruled that capital gains were changes in asset prices, not income subject to tax (*Gray v. Darlington*). Following the 16th Amendment, which permitted taxes on “income from all sources,” the Congress included such gains in taxable income. But in 1921, the Supreme Court found that gains fell within the meaning of income, settling the legal debate. Also in 1921, Congress began to offer reduced tax rates on long term gains.

The double taxation of corporate income, including capital gains taxes

The inherent double tax nature of taxation of gains is compounded by, and sometimes confused with, the double taxation of corporate income. In the United States, earnings of “Schedule C” corporations are subject to corporate tax, and the dividends they pay to shareholders out of after-tax income are also taxed at the shareholder level. Capital gains that arise on the sale of the shares are also taxed, whether the gains are due to retained after-tax earnings or to other factors that cause the price to rise.

Unlike many other nations, the United States does little to “integrate” the corporate and individual income taxes. That is, US law does not allow a deduction at the corporate level for dividends paid, and does not allow dividend recipients a tax credit for the tax the corporation has already paid on the income distributed as a dividend. Nor is there an adjustment in the tax basis for retained after-tax earnings in calculating a capital gain.

Many people are familiar with the label “the double taxation of dividends.” The double tax moniker is equally applicable to retained earnings that increase the corporation’s value. Whether kept as cash, or invested in assets that, in turn, will earn future income of equal or greater value than the cash, the retained earnings raise the value of the company. If the shares are sold, the shareholder has a taxable capital gain. Thus, the double taxation of corporate income falls on retained earnings as well as on dividends. Any other source of price appreciation also leads to double taxation. The only difference is in the timing. Unlike dividends, the shareholder may defer the capital gains by holding onto the assets.

The double tax nature of the capital gains tax arises just as surely in the case of a non-corporate asset. After-tax income can be reinvested in a non-corporate business as well as in a corporate firm, and an improved profit outlook from any cause can boost the value of the non-corporate business. Whatever the type of business, if those earnings estimates are revised upward, the current value of the business will increase. Taxing the current gain in value would be double taxation of the future earnings.

A differential tax rate for capital gains is sometimes rationalized as an offset to the double taxation of corporate income. However, that is really an integration issue. The primary reason for a rate differential remains the inherent double taxation of the present value of the future earnings.

Economic consequences of taxing capital and the choice of a tax base

Imposing additional layers of tax, and thereby raising the tax rate, on the earnings of capital discourages capital formation, which in turn reduces labor productivity and wages. Capital is highly mobile. It may move abroad, or it may not be formed at all if the rewards are not satisfactory. Income that would have gone into capital formation may be used for consumption instead. These economic repercussions should be considered in the choice of a tax base: “income” (including capital gains) versus “consumed income” (a.k.a. cash flow, or consumption).

Capital gains under an income tax

Public finance practitioners and tax theorists in the legal community generally regard capital gains as falling under the ideal theoretical definition of income for tax purposes. In the second quarter of the 1900s, Professors Henry M. Simons and Robert Haig defined income as the increase in one’s ability to consume in a given year (whether the consumption was undertaken or not). Income would consist of earnings used for immediate consumption, or for adding to wealth (current saving), plus any increase in the value of existing assets (accruing capital gains). Haig and Simons would have liked to tax capital gains as they accrued. However, it is difficult to assess the change in value

of assets that are not traded in the market, so in practice gains or losses are taxed or deducted when the assets are sold, instead of annually on accrual.¹

In effect, Haig and Simons were trying to develop a tax base that reflects the changes in the taxpayer's "ability to pay." The increase in the price of an asset that reflects higher expected future income gives the taxpayer the ability to increase consumption in the present by tapping the higher presumed future income now. Doing so, however, would run the risk that the future income may not materialize. Taxing that ability to consume today is, in essence, taxing the rise in the taxpayer's wealth, and in doing so, taxing his future income before it materializes. Haig and Simons sought to include this change in wealth in the tax base in part because they wished to facilitate the redistribution of wealth (see below.)

This definition of income is broader than economic income (payments received for current production), and a tax system based on it is called a "broad-based income tax." The term "broad-based" should be understood to mean that the income concept itself is "broad," not that the tax is imposed "broadly," with few deductions or exceptions, on some universally recognized concept of income.

The broad-based income tax falls more heavily on income that is saved than on income that is consumed. Both the initial saving and the subsequent returns on that saving (which are what one is "buying" by saving) are taxed. By contrast, income used for consumption is taxed when earned, but except for a few excise taxes, the consumption is not taxed again at the federal level. (The states and some localities impose sales or other consumption taxes. They also follow the federal practice of imposing multiple layers of taxation on saving and its returns.)

Saving is a cost of earning future income. The opportunity cost of tying up the saving, equal to the time value of money, reflects the marginal rate of time preference that we all sense. People simply do not regard a dollar a year from now as being as valuable as a dollar today. Interest payments or other earnings that merely match this time sense are simply compensating

1 Dealers in securities are required to mark to market their inventory of financial assets and derivatives and pay tax on the accruals at ordinary tax rates. Individual investors who qualify for trader status and wish to be exempt from the \$3,000 annual cap on capital losses may elect to mark to market and pay ordinary tax rates (U.S. Tax Code Section 475).

for the perceived cost of saving and delaying consumption, leaving the saver just indifferent between doing the saving and consuming immediately. The interest recipient does not regard the payments as increasing well-being, that is, as really raising income. A tax system that disregards this time cost of money, and taxes these minimal returns, biases the choice between saving and consumption against the former in favor of the latter, and causes the taxpayer to save less and consume more than in the absence of a tax. The Haig Simons concept of income treats minimal earnings on saving that barely equal the time value of money as additional income. In doing so, it creates a tax system that is not “saving-consumption neutral.” This non-neutrality affects dividends and business profits, as well as capital gains.

Capital cost recovery (the deduction of the cost of plant, equipment, and structures from revenue to determine business income) in the Haig Simons world would be based on economic depreciation, defined as the reduction in the value of an asset as it becomes obsolete or wears out over time. In theory, one could sell a capital asset a year after buying it, recovering a portion of the initial cost which could be used for consumption. Therefore, only the drop in value from one year to the next would be considered a reduction in the ability to consume. If an asset were sold, any cost recovered in excess of economic depreciation would be viewed as a capital gain, and would be taxable.

There are two problems with this approach to cost recovery. First, economic depreciation is impossible to determine. Assets lose value at wildly varying rates over time, as technology and economic conditions vary, and they have different rates of wear and obsolescence as they are used in one industry versus another. Whatever cost recovery schedule is set up in the tax code cannot match economic depreciation correctly at any point in time, and even if it could, it would be wrong a few months later.

Second, the concept of economic depreciation is implemented in practice by imposing lengthy asset lives, or write-off periods, for tax depreciation. This requires businesses to deduct the cost of their investment outlays over long periods. The delay reduces the value of the write-offs by the time value of money plus inflation; it accelerates tax payments, and reduces the return on capital. The true cost of an asset is its purchase price, which is locked up at the time of purchase. This is the opportunity cost of tying up the money in the machine, building, or other asset. Any depreciation schedule less than

immediate write-off (expensing) raises the cost of the capital, and creates a tax bias against investment in favor of consumption.²

The purpose of the Haig Simons income definition was to justify a tax system structured to redistribute wealth. Simons was aware that such a tax system, especially if it included graduated tax rates, would retard saving and investment and lower national output. He wrote that graduated rates could only be justified on the basis that the existing distribution of wealth was “evil or unlovely.” He stated:

The degree of progression in a tax system may also affect production and the size of the national income available for distribution. In fact, it is reasonable to expect that every gain, through taxation, in better distribution will be accompanied by some loss in production ...

[I]f reduction in the degree of inequality is a good, then the optimum degree of progression must involve a distinctly adverse effect upon the size of the national income ...

With respect to capital accumulation ... the consequences are certain to be significantly adverse ... [I]t is hardly questionable that increasing progression is inimical to saving and accumulation ... That the net effect will be increased consumption ... hardly admits of doubt. (Simons, 1938: 18–20)

Simons proposed to offset the negative effect on capital accumulation by having the government run perpetual surpluses to bolster national saving. This has not happened in practice. Even if it did, it would not remedy the adverse effect on investment; the reduced after-tax returns on investment would continue to discourage capital formation.

2 This is true even in the case of a debt-financed investment, where the investor is allowed a deduction for debt service. The deduction for the debt service may appear to be a second write-off for a portion of the cost of the asset, which, with expensing, might appear to produce a double deduction and a negative tax rate. However, the lender is taxed on the debt service, and his tax, along with that of the investor on the remaining returns, results in the appropriate, neutral tax on the earnings. In effect, all of the net return on the asset (revenue less the purchase cost) is taxed either at the level of the business or at the level of the lender.

Simons was speaking specifically in this section of the text about graduated tax rates. A key point to remember, however, is that the bias against saving in his ideal tax system does not stem only from the graduated tax rates, but is also due to inclusion of both saving and the returns to saving (including capital gains) in the tax base.

Capital gains in a consumed-income or cash flow tax with “saving-consumption neutrality”

Professor Alfred Marshall preferred a graduated consumption-based tax to an income tax, because the consumption base led to more growth of income, and ultimately, revenue: “[T]here is a general agreement that a system of taxation should be adjusted, in more or less steep graduation, to people’s incomes; or better still to their expenditures. For that part of a man’s income, which he saves, contributes again to the Exchequer until it is consumed by expenditure” (1982: 661).

A consumption-based, consumed-income, or cash flow tax puts the same tax burden, in present value, on current consumption and saving for future consumption. The explicit consumption taxes, such as the VAT and sales tax, are obviously neutral. Whether one consumes the income immediately and pays the tax, or saves the income, at interest, and spends the augmented total at a later date and pays an augmented tax, the present value of the tax is the same.

For taxes levied on individuals, there are two possible approaches to tax neutrality. In the saving-deferred approach, income used for saving is tax deferred, along with any reinvested future earnings. All returns are taxed when the saving is withdrawn for consumption, including any embedded capital gains. Alternatively, under the returns-exempt approach, the saving is taxed when first earned, and the subsequent returns (including capital gains) are not taxed. Some people refer to these neutral types of tax as “consumption taxes,” but the tax need not be imposed at point of sale like a sales tax or VAT to qualify as saving-consumption neutral. A neutral tax could look much like the income tax, but with a deduction for net saving and a tax on net withdrawals. The deferral would cover all saving, not just the amounts currently covered by pensions and retirement saving arrangements.

In a neutral tax, capital outlays for plant, equipment, buildings, land, and inventory would be expensed. Under expensing, the outlay for an asset is

fully deductible at the time of purchase; any subsequent recovery of a portion of the cost if the asset is sold is taxable at the time of the sale, including any embedded capital gain. Any returns rolled over into new investment would continue to be tax deferred. By deducting costs as soon as they occur, the deductions do not lose the time value of money while the taxpayers waits to claim them. Taxing returns only when they are received does not accelerate the tax collection and raise its cost in present value terms. In this manner, the time value of money is taken accurately into account, and the tax system is saving-consumption neutral. (Any borrowing to fund the investment would first be taken into income. Any subsequent debt service, including principal repayment, would be deductible.)

Taxes on the returns to capital could be collected at the individual level, in the cash flow saving-deferred tax, as saving was withdrawn for consumption. Corporate income could be treated as pass-through income, with deferral of reinvestment. Alternatively, it could be taxed at the business level, on sales less all costs, including investment, and not taxed again at the shareholder or owner level. There would be no double taxation of corporate income. As long as the same tax rates applied at either end (on the individual or on the corporation), either method would yield the same revenue, except for the presence of tax exempt entities, such as charities, schools, and other non-profits.

These neutral taxes allow more capital formation and saving than the broad-based income tax. Neither type of saving-consumption neutral tax would treat capital gains differently from other income. In fact, there would be no separate calculation of capital gains at all. Gains would simply be embedded in other cash flow totals, or in returns exempt from tax. Either approach would make the system saving-consumption neutral.

Professor Leonard Burman has acknowledged that a consumption-based tax would solve the problem of the differential tax treatment of capital gains. He states, however, that if a country is to have an income tax, it should tax capital gains, because that is what an income tax means (Burman, 2012). This view raises two objections.

First, the US Congress has never enacted a “pure” income tax. The US tax system is a hybrid, with some features of the tax base resembling that of an income tax system and some features resembling that of a consumption or neutral tax. Among other departures from purity, it has almost always

allowed some offsets to the tax biases against saving and investment, either through some form of accelerated depreciation, retirement saving arrangements that resemble cash flow treatment, and/or reduced tax rates on long term capital gains, and sometimes reduced tax rates on dividends. The current retirement arrangements use both the saving-deferred approach to neutrality, as in ordinary pensions and IRAs (individual retirement accounts), and the returns-exempt approach, as with Roth IRAs and tax exempt state and local bonds. In spite of the exceptions, Congress calls this an income tax. The label is not what matters.

Second, the Haig Simons definition of income is arbitrary. It is no good condemning differential tax treatment of capital gains simply because it violates the definition of income one prefers. If the definition of income includes gains, then the violation is a tautology, and begs the question of whether it is good economic or tax policy. That the Haig Simons income concept is well known and favored by tax theorists does not make it widely known and accepted by Members of Congress or the public. The Congress is free to define income for tax purposes however it wants, and to still call the tax an income tax.

Tax treatment of capital gains in the United States

In the United States, short term capital gains on the sale of assets held for a year or less are treated as ordinary income. Gains on the sale of assets held more than one year are considered long term gains. Long term gains are taxed at a preferential lower tax rate: zero percent if the taxpayer is otherwise in the US 10 percent or 15 percent tax bracket; 15 percent for other taxpayers with taxable incomes up to \$400,000 (single filers), \$450,000 (married filing jointly), and \$425,000 (single head of household, i.e., with children); and 20 percent for higher income filers.³

3 The top of the 15 percent bracket in 2014 is \$36,900 for single filers, \$73,800 for joint filers, and \$49,400 for heads of households. These thresholds are adjusted annually for inflation. Qualified dividends, which are dividends from corporations that have paid corporate taxes, also receive these reduced tax rates. That part of capital gains or qualified dividends that would fall into the 10 percent or 15 percent brackets if other income did not exhaust those brackets gets the zero tax rate. Gains and losses on traded stock options that are not exercised are always considered

In limited cases, section 1031 of the tax code permits “like-kind exchanges” that allow the deferral of gains on existing equipment or other real property used in a trade or business. The property given up and the property acquired must be of the same type and of equal value, the new property must be “identified” within 45 days of the disposition of the original asset and acquired within 180 days, and the owner must not receive “constructive receipt” of the sale proceeds in the interim. Inventory, stocks and bonds, other financial assets, and personal residences are not eligible, and many restrictions apply to depreciable property and livestock to ensure they are “like-kind” assets.

Gains that occur in tax-deferred retirement plans, such as regular IRAs (individual retirement accounts), and 401(k) and similar plans, are deferred until withdrawals are made from the accounts, at which time they are taxed as ordinary income. Rollovers and consolidations among plans are permitted without triggering tax, with some limitations on frequency. Withdrawals from IRAs, 401(k), and similar plans must begin by April 1 of the year following the one in which the account holder reaches age 70 ½. Early withdrawal before age 59 ½ is subject to tax plus a 10 percent penalty. By contrast, “Roth” IRAs or 401(k)s are plans in which the contributions are made with after-tax money; the earnings and gains on such plans are not taxable (provided the account has been open for a minimum of five years and the withdrawals occur after age 59 ½) and there is no mandatory age at which withdrawals must commence.

Long-term capital gains held until death are not subject to capital gains tax. Heirs and beneficiaries receive a “step-up” in tax basis on the assets (they are assumed to have acquired the assets at the value at the time of death of the decedent) and would owe tax only on any subsequent rise in value after that date.⁴ The step-up is intended to protect the gains from facing both a capital gains tax and an estate tax.

short term. If the options are exercised, the gain or loss is made part of the stock transaction and given the same long or short term treatment as the underlying asset. A special exclusion from tax (\$250,000 for single filers and \$500,000 for married couples) is granted on gains on a principal residence in which the seller has lived for at least two of the last five years before the sale. The exemption may be used repeatedly on subsequent residences as long as the two year residency requirement is met. This arrangement replaced an earlier “roll-over” feature that allowed the entire home sale to be reinvested in another residence.

4 In the case of inherited IRAs and other retirement plans, beneficiaries must begin withdrawals by the end of the year following the death of the owner. Withdrawals from inherited tax deferred plans are taxable as ordinary income.

Benefits to the economy from the differential capital gains tax rate

The enforcement and compliance costs of having a tax rate differential on capital gains in the individual income tax must be weighed against the economic benefits and the revenue consequences. The tax rate differential creates some tax administration and compliance costs. The lower tax rate would appear to reduce tax revenue at a given level of economic activity. There are additional losses due to tax avoidance or evasion actions. On the other side of the balance, capital formation, wages, and employment are higher with a reduced tax bias against capital formation. Tax revenues rise with a stronger economy and higher incomes.

To decide whether a capital gains differential is worth the cost, one must estimate the economic and revenue effect of eliminating the capital gains rate differential. The capital gains tax is part of the cost of utilizing capital—the service price. The service price of capital is the pre-tax rate of return required to yield a minimum after-tax return to the investor. The total pre-tax return must cover economic depreciation, risk, and all taxes paid, less any tax credits or subsidies received.

The higher the service price is, the smaller is the amount of capital that can be profitably created and employed. The lower the service price, the larger the capital stock will be. The capital stock, combined with the labor services of the work force, determines the amount of output and income in the economy. The higher the capital stock is, the higher is the productivity of the workforce, and the higher the wage and the levels of employment and hours worked.

The Tax Foundation Taxes and Growth model is a neoclassical tax and economic simulation model driven by the service price of capital and the weighted average tax rate on labour income.⁵ The model finds that eliminating the preferential tax rate on capital gains for individual taxpayers, with the government retaining the revenue, would ultimately depress the level of GDP by 2.5 percent and the level of the capital stock by 7 percent (table 1). Tax changes affecting employment and the formation of capital equipment begin

5 Information about the model is available on the Tax Foundation web site at <<http://taxfoundation.org/taxes-and-growth>>.

**Table 1: Eliminating the capital gains differential:
economic and budget changes versus 2013 law**

GDP	-2.50%
Private business GDP	-2.59%
Private business stocks	-6.97%
Wage rate	-2.11%
Private business hours of work	-0.49%
Jobs (thousands)	-473.4
Static revenue estimate (2013 \$ billions)	\$82.4
Federal revenue (dynamic) (2013 \$ billions)	-\$11.8
\$GDP (2013 \$ billions)	-\$407.2
\$GDP/\$tax increase (dollars)	\$34.5
<i>Weighted average service price</i>	<i>% change</i>
Corporate	6.70%
Noncorporate	-0.01%
All business	4.70%

quickly, and usually reach their full effect in about five years; for structures, they appear to reach full effect within ten years. Thus the full adjustment of the capital stock, wages, and employment takes less than a decade.

Without the differential, the wage rate would be 2.1 percent lower, and there would be 473,000 fewer full time equivalent jobs. The apparent revenue gain under static analysis (assuming no change in GDP) would be just over \$82.4 billion a year. However, the reduction in GDP and taxable income would more than wipe out the presumed gain on a dynamic basis, for a yearly loss of nearly \$12 billion (after allowing for the change in GDP after all economic adjustments, taking about 5 to 10 years).

It may seem that an increase in the tax rate on capital gains might be used to reduce other taxes, but that is not the case when dynamic analysis takes the economic consequences into account. However, if the government were to act on the illusory static revenue gain presumed to arise from the higher capital gains tax rate, and cut income tax rates across the board by an equivalent static amount, the loss in GDP would be cut to just under 0.9 percent, and the loss in the capital stock to less than 3.3 percent ([table 2](#)). Somewhat over half of the wage and job loss would remain. However, the dynamic revenue outcome would be a loss of \$31 billion annually. Since the

Table 2: Eliminating capital gains treatment using static revenue for general rate reduction: economic and budget changes versus 2013 law

GDP	-0.89%
Private business GDP	-0.88%
Private business stocks	-3.29%
Wage rate	-1.15%
Private business hours of work	0.28%
Jobs (thousands)	265.9
Static revenue estimate (\$ billions)	\$0.2
Federal revenue (dynamic) (\$ billions)	-\$31.2
\$GDP (\$ billions)	-\$145.6
\$GDP/\$tax increase (dollars)	\$4.7
<i>Weighted average service price</i>	<i>% change</i>
Corporate	4.09%
Noncorporate	-1.29%
All business	2.49%

capital gains tax rate increase would actually lose revenue on a dynamic basis, the government would have to raise other tax rates to compensate for the revenue loss. There would actually be no revenue gain to fund a reduction in other tax rates.

Reasons for a rate differential

The public finance and law literature discusses several reasons for a capital gains tax rate differential. The reasons frequently cited are incomplete, and often phrased in an unfortunate way.

Encouraging investment

As shown above, a lower tax rate on capital gains would result in more investment than under current law. Sometimes referred to in the literature as encouraging investment, a lower rate would be better described as doing less to thwart it, relative to a more neutral tax less biased against saving. This can be rationalized simply by citing the sensitivity of capital formation to taxation. However, other taxes on capital income have a similar effect on

capital formation. These include taxes on dividends, the tax treatment of cost recovery (depreciation allowances), property taxes, etc. The key difference with respect to capital gains is the double tax nature of the levy, making relief all the more urgent. Ideally, all of the tax biases against saving ought to be eliminated so as not to favor one type of investment financing over another, or one form of business over another.

Offsetting inflation

Some portion of capital gains represents inflation, not a real increase in value. The current tax law does not adjust the tax basis of a capital asset for inflation. A lower tax rate on long term gains may be viewed as a crude correction for the inflation element in the gain. The correction is not exact. Assets may be held for varying lengths of time, and be subject to more or less inflation. No single lower rate could correct for inflation in assets held for different time periods. Indexing the tax basis for inflation would be a more exact approach. This begs the question of what to do about other aspects of the tax system that are not adjusted for inflation, such as the capital consumption allowances, insofar as they must be taken over time rather than immediately expensed.⁶

Bunching

A capital gain may reflect years of reinvestment and rising asset value, yet it is taxed in the year it is realized. If it is taxed as ordinary income, and if the income tax includes a graduated tax rate structure, the capital gain will fall into the taxpayer's top tax bracket and may spill over into higher tax brackets. It would face a higher tax rate than if it were spread over time. (The same issue arises in occupations with larger variability in income, such as farming, fishing, or writing. Income averaging can be applied in those cases.) A lower tax rate on long term gains can be viewed as relief from the higher tax rate incurred by the bunching of the gain into a single tax year. As with inflation, a single lower rate unrelated to the length of the holding period cannot precisely offset bunching. It could be argued in rebuttal that the advantages of deferral

⁶ One has less concern over failure to adjust interest and principal for inflation, as there are offsetting effects on the borrower and the lender in the case of unexpected inflation which have little impact on tax collections. Where inflation is anticipated, the effects are offset by changes in market interest rates. Inflation indexed bonds can reduce risk further.

of the tax make up for the higher effective tax rate from bunching, but that argument assumes that taxing accrued gains is optimal policy, and that the deferral is an unmerited tax preference instead of an offset to double taxation.

Unlocking

High tax rates on capital gains encourage savers to hold stock longer than they otherwise might. This lock-in effect hampers the reallocation of individuals' portfolios, and may interfere with the efficient reallocation of saving. Reducing tax rates on capital gains should unlock some of the pent-up gains, and yield at least a short-run rise in revenue for the Treasury. Indeed, several studies done at the Treasury in the 1980s, and other more recent research, suggest that the unlocking effect of a lower rate may last for a considerable time, and raise revenue for years, if not permanently.

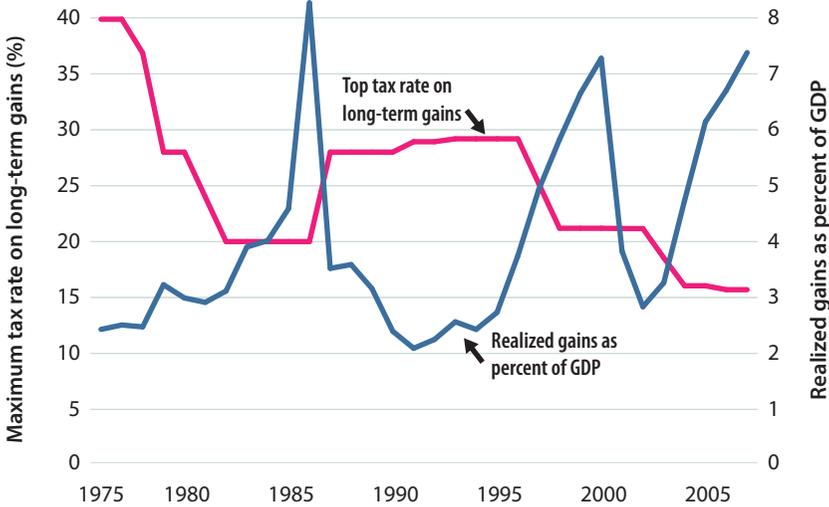
As evidence, consider the effect of the increase in the tax rate on capital gains enacted in 1986. The Tax Reform Act of 1986 reduced tax rates on ordinary income and eliminated the tax rate distinction between long term capital gains and ordinary income for individuals. The top capital gains tax rate increased from 20 to 28 percent effective in 1987. In 1986, taxpayers reacted to the pending tax rate increase by nearly doubling the amount of realizations. After the rate increase, realizations fell below 1985 levels both in nominal dollars and as a share of GDP. Realizations as a share of GDP remained depressed until the Tax Act of 1996 lowered the tax rate on long term gains back to 20 percent, effective in 1997. The expected tax revenue from the 1986 increase in the tax rate completely failed to materialize ([figure 1](#), [table 3](#)).

The long duration depression of capital gains realizations came as a surprise to the federal revenue estimators. Their methodology assumed that realizations would return to normal levels within a year or two of any change in the tax rate. Accrued gains were assumed to bear a steady relationship to GDP, which would require a prompt return to normal levels of realization to maintain that relationship. This did not happen in the 1987–1997 period.

More recently, the American Taxpayer Relief Act of 2012, passed in January, 2013, increased the top tax rate on long term capital gains and qualified dividends with some advance notice.⁷ The Congressional Budget Office expected the rate change to trigger a surge in realizations in calendar 2012

7 The name of the Act notwithstanding, upper income savers did not receive tax “relief.”

Figure 1: Capital gains realizations rise when the maximum tax rate on long-term gains falls, 1976–2007



Source: See table 3.

to avoid the rate increase, but a dip in realizations in calendar 2013. CBO estimates that this timing shift would raise revenue in fiscal year 2013 and reduce revenue in fiscal 2014. It does not estimate a continued effect beyond 2014, contrary to the historical record (Congress of the United States, 2013). Another surprise is likely.

More formal econometric work exists to back up the visual impression displayed in the graph. In 1988, Darby, Gillingham, and Greenlees utilized Treasury panel data to look at the realization effects following the 1978 reduction in the top capital gains tax rate to 28 percent and the 1981 reduction in the top rate to 20 percent. They concluded that both steps “were significantly revenue-raising” (1988: 4). This implies that the rate increase to 28 percent in the 1986 Tax Reform Act would be revenue losing.⁸

Three Treasury papers from the Office of Tax Analysis in 1989 confirmed earlier Treasury estimates of a significant taxpayer response to changes in the capital gains tax rate (Jones, 1989; Gillingham et al., 1989; Auten et al., 1989).

⁸ For a description of the model, please visit the Tax Foundation web site at <<http://taxfoundation.org/taxes-and-growth>>.

Table 3: Long-term capital gains realizations, taxes paid, and average effective and maximum tax rates

	Realized long-term capital gains (\$ millions)	Taxes paid on long-term capital gains (\$ millions)	Average effective tax rate (%)	Realized gains as percent of GDP (%)	Maximum tax rate on long-term gains (%)
1977	43,755	7,870	18	1.57	39.875
1979	70,493	10,405	14.8	2.25	28
1980	69,856	10,817	15.5	2.23	28
1981	77,071	11,934	15.5	2.37	28.00/20.00
1982	86,087	12,500	14.5	2.65	20
1983	116,015	17,134	14.8	3.28	20
1984	135,936	20,365	15	3.46	20
1985	166,356	25,178	15.1	3.94	20
1986	318,944	50,834	15.9	7.15	20
1987	140,386	31,791	22.6	2.96	28
1988	153,271	36,746	24	3.01	28
1989	141,069	32,351	22.9	2.57	28
1990	115,671	25,900	22.4	1.99	28
1991	98,363	21,581	21.9	1.64	28.93
1992	114,060	25,847	22.7	1.8	28.93
1993	134,469	31,393	23.3	2.02	29.19
1994	140,392	33,092	23.6	1.98	29.19
1995	158,955	38,368	24.1	2.14	29.19
1996	233,872	58,782	25.1	2.98	29.19
1997	330,360	69,572	21.1	3.96	29.19/21.19
1998	424,762	80,611	19	4.83	21.19
1999	482,181	91,416	19	5.16	21.19
2000	588,061	111,507	19	5.91	21.19
2001	322,831	58,750	18.2	3.14	21.17
2002	251,301	44,984	17.9	2.36	21.16
2003	294,811	44,903	15.2	2.65	21.05/16.05
2004	466,224	66,154	14.2	3.93	16.05
2005	648,430	92,304	14.2	5.14	16.05
2006	750,771	106,568	14.2	5.61	15.7
2007	861,220	122,036	14.2	6.14	15.7
2008	463,614	61,387	13.2	3.24	15.35
2009	225,336	28,228	12.5	1.62	15.35

Notes: Data include returns with positive long-term gains in excess of any short-term losses. Data for each year include some late-filed prior year returns. The maximum rate is the effective rate applying to high-income taxpayers, including effects of provisions that alter effective rates for significant amounts of gains. Maximum rates include the effects of exclusions (1954-86), alternative tax rates (1954-86, 1991-97), the minimum tax (1970-78), the alternative minimum tax (1979-), income tax surcharges (1968-70), and phaseouts of itemized deductions (3% 1991-2005, 2% 2006-07, 1% 2008-09). The maximum statutory rate on long-term gains was 28% starting 1991, 20% starting May 1997 and 15% starting May 2003. The 2009 maximum rate includes the effect of the 1% itemized deduction phaseout, computed as $15.35 = 15 + .01 \times 35$. Starting 1997, gains on collectibles and certain depreciation recapture are taxed at ordinary rates, up to maximum rates of 28% on collectibles and 25% on recapture. Midyear rate changes occurred in 1978, 1981, 1997 and 2003. Estimates are subject to revision.

Source: Department of the Treasury, Office of Tax Analysis, 2012.

A paper by Lawrence Lindsey concluded “that capital gains tax revenues are maximized at [a] 20 percent rate or lower, with a central estimate of 16 percent. Some of any gain in revenue may be temporary, but ... even in the long run about 5.4 percent more capital gains will be realized for every one percentage point reduction in the capital gains tax rate” (1986: i).

A paper by Joel Slemrod and William Shobe concluded that short term responses to rate changes were larger than permanent effects, but also stated: “The estimated magnitude of the realization response is large enough to substantially mitigate the revenue loss that a tax reduction would otherwise cause and may, especially in the short run, be large enough to generate an increase in revenue” (1990: i). These results were estimated in 1990 when the prevailing tax rate was 28 percent.

A 1994 cross-section study by Burman and Randolph employed state income tax rates as well as federal to get a combined marginal tax rate on realized gains. Their sample and equations produced a higher estimate of the transitory response, and a lower estimate of the permanent response, than some earlier work.

A paper by Paul Evans extended earlier panel studies by the Treasury using additional panel data (the Internal Revenue Service’s 1985-based Sales of Capital Assets 10-year panel study, of 13,000 taxpayers tracked over 1985–1994; arranged by permanent income, mean over period in 1982 dollars). Evans found the revenue-maximizing tax rate for capital gains tax receipts to be a fraction under ten percent. Evans’s work suggests a permanent improvement in tax revenue at capital gains rates lower than current levels. As with the earlier work, this was based only on the realizations effect, and measured only the capital gains tax revenue. Evans noted that the revenue-maximizing rate for total federal revenue would be nearer zero, because of the growth effect of reducing the capital gains tax rate (Evans, 2009).

More recently, Dowd et al. (2012) used a data panel spanning 1999 to 2008 and found that “a preferred persistent elasticity estimate is -0.79, and the transitory estimate is -1.2.” They estimate that the short run effect would be a revenue gain relative to what would have occurred under the old tax rates. Longer term, there would be a small revenue loss; a lower tax rate would recoup most but not all of its revenue based on the realizations effect. These budget effects are from the realizations of gains sooner than otherwise, and

do not include the additional federal revenue from a larger capital stock and GDP spurred by the reduction in the service price of capital.

Issues in distinguishing capital gains from ordinary income

Defining capital gains

Stanley Surry (1956) provides an excellent background analysis of the complexity of taxing capital gains in a review of the then-new 1954 Internal Revenue Code. The presentation is still one of the best, although some of the issues have since been dealt with by Congress and regulation.

Surry points out that a capital gain is defined in tax law as a gain obtained from the sale or exchange of a capital asset, which then raises the question: “What is a capital asset?” Not all property qualifies; a number of exceptions are listed. Surry points out that by defining capital gains and losses in part by stating what are *not* capital gains and losses, the law leaves a lot of room for people to design new assets or financial arrangements that are not on the proscribed list. The Treasury must then scramble to block such devices when it feels they go too far afield of the intent of the statute, or of economic sense.

Surry lists a number of categories into which the ambiguities may be divided. One is the distinction between investment and business. One type of property not considered to be a capital asset is property that is stock in trade that should be treated as inventory or for sale to customers in the ordinary course of the business. The law makes an effort to distinguish between business use of property and portfolio investment by savers. Gains arising in the business case are treated as ordinary gains; for the savers, they are treated as capital gains. But the lines are not clearly drawn. Surry gives several examples:

- ♦ A person in the business of property development must report gains on land sales as ordinary income. An individual investor buying land as a long term investment may report a gain as a long-term capital gain. Surry asks, suppose a college professor buys unimproved land as a long-term investment. Selling the land years later at a profit would normally qualify as a long-term capital gain. However, if he must add improvements and market the land to dispose of it, has he crossed the

line and become a developer? (Developers' profits, including capital gains, are taxed as ordinary income at ordinary tax rates.)

- What if the land was originally bought for a cattle ranching operation, which later fails. If the land is sold in parcels over time, has the rancher become a professional developer with an ordinary gain?
- What if an individual or an estate is selling off a large collection of antiques or jewelry accumulated over time for personal use or enjoyment? Has the individual or estate become a business?

Congress has dealt with some such cases in the tax code, and Treasury has written regulations, but they cannot anticipate all possible situations. The outcome is not perfect, but it works well enough in most cases.

Legitimate questions of interpretation of these restrictions can end up in court. One famous example is the case of futures contracts entered into by the Corn Products Refining Company, which used large quantities of corn to produce starch and sugar. The company purchased corn futures to assure a steady supply if a shortage were to develop. As grain was bought on the spot market without recourse to the futures, the futures were sold, often at a profit. The company wanted to call this profit a capital gain, arguing that the futures were capital assets not disallowed by the list of exceptions. The Supreme Court ruled that the futures trades were closely related to the purchase of raw materials for the ordinary business of the company, and the gains should be treated as ordinary income (Surry, 1956).

Another distinction is the differential treatment between dealers, speculators, and savers. Brokers who make a market in stock, bonds, or futures contracts, and who hold contracts as part of their ordinary business, must treat the gains and losses as ordinary income. Individuals who include these assets as part of their investment portfolios may treat the gains and losses as capital gains and losses. Speculators are hard to distinguish from savers. Surry suggests that the holding period for capital gains was intended to separate short-term speculation from long-term saving.

Surry also discusses issues with the treatment of recurring receipts such as wages, rents, interest, dividends, and royalties versus non-recurring receipts relating to increases in the value of property. He notes the apparent

aberration of treating timber and coal royalties as capital gains while other royalties are ordinary income. He finds further difficulties with the transformation of tangible assets into intangible assets and the retention of earnings rather than the payment of dividends (which allow the property or retained earnings to be realized as a capital gain rather than ordinary income).

Clearly, the concept of a capital gain can be ambiguous, and it may be difficult to pin down the precise rule to be followed in every business and investment arrangement. Nonetheless, the vast bulk of capital gains occur where the meaning and the tax treatment are clear. The gray areas are on the fringes of normal activity. Few business operations are in ambiguous settings where the classification is genuinely uncertain and as yet undecided by existing regulation or court rulings.

Relatively few people participate in elaborate tax planning exercises of a questionable nature that seek to test unchartered waters. The Treasury has been too vigilant, and the penalties for overstepping reasonable behavior have been too harsh, to offer much of a risk-adjusted return. A case in point was recently covered by a Senate hearing, described below.

The key point to remember in considering these issues is that they are related to special and limited cases. They impose some limited costs on the enforcement mechanism, but should not decide the question of having a rate differential or not in isolation. One must also consider the merits of tax neutrality and the economic gains associated with a lower tax rate on capital income.

Three tax issues that make a clear definition of capital gains important

The important point to consider is that the clarification of such issues by the courts over time has narrowed the range of future disputes. Many other issues have been dealt with through an accumulating set of IRS regulations, and others have been handled with input from Congress by amendments to the tax code. The Treasury has acquired enormous expertise in enforcing the definitions, distinctions, and regulations over the last century.

The tax code makes three important distinctions between capital gains and ordinary income. The first is the preferential tax rate accorded long term capital gains. The second is the ability to defer tax until the asset is sold or

exchanged. The third is the different treatment given to capital gains and losses as opposed to ordinary gains and losses.

- 1 Individuals get a lower tax rate on long term capital gains than on ordinary income. Enforcement and compliance issues may arise if the lower rate and ability to defer tax lead to efforts to convert ordinary income into capital gains in a manner not intended by the law. In particular, the lower rate may create incentives to receive investment returns in the form of capital gains rather than dividends or interest. Prior to the Jobs and Growth Tax Relief Reconciliation Act of 2003 (“JGTRRA,” Pub.L. 108–27, 117 Stat. 752), dividends were treated as ordinary income, while capital gains received a preferential tax rate. Consequently, it was necessary to determine whether a corporate share redemption was to be treated as a capital gain or a dividend. Safe harbor and other code provisions deal with the issue (Doernberg, 1982). Such issues became less important after JGTRRA, which equalized the tax rates applicable to long term capital gains and qualified dividends (dividends subject to a corporate level tax).
- 2 Individuals and businesses may both defer gains until the assets are sold or exchanged.
- 3 Schedule C corporate capital losses may be deducted against capital gains, but, with a limited exception, not against ordinary income. C-corporations may not deduct any losses against ordinary income. Excess losses may be carried back three years, or forward for up to five years, after which they expire.⁹ (Carryback is not allowed for registered investment companies.) This can put pressure on corporations facing the expiration of capital losses or delay in the use of capital losses. The businesses may either attempt to manufacture capital gains or to recast capital losses as ordinary losses to be used to offset ordinary income.

9 In the case of foreign expropriation, the carry-forward is ten years.

Individuals and pass-through businesses may deduct up to \$3,000 a year in losses against ordinary income, but must carry the rest forward.¹⁰ There is no expiration. These distinctions encourage taxpayers to prefer ordinary losses to capital losses, and may encourage efforts to transform the latter into the former.

These issues are not due to a differential tax rate for capital gains, but to timing and the ability to deduct losses. That is why the law maintains the separate characterization of capital gains and losses versus ordinary income even in periods where no rate differential exists (such as 1988–1996, following the full effect of the 1986 Tax Reform Act). The government does not want firms to shelter ordinary income from tax by means of a capital loss, or to shift the timing of the tax liability by recognizing losses now, and letting gains run. Another fear is that profitable firms might buy out money-losing or bankrupt companies to use their carry-over tax losses against the ordinary income of the profitable company (a practice also limited in current law when firms try to use acquired losses against capital gains).

Without restrictions on the deduction of losses, taxes on ordinary operations or income might be deferred by means of offsetting options contracts with the losing end of the trade coming due in the current tax year, and the gain in the following year. Ordinary options contracts have no independent output or income associated with them. They are bets on the movement of the price of a commodity or financial instrument, and are generally zero sum games. If the two parties to the option are domestic taxpayers, one party's gain is the other party's loss, and, if they are in the same tax bracket, the outcome is a revenue wash for the Treasury. An issue may arise if one of the parties is foreign, and not subject to the domestic tax authority.

10 Taxpayers may take losses frequently while they are still short term and can be deducted against ordinary income, while delaying gains until they are long term to get a more favorable tax rate. However, US law limits the taking of losses against ordinary income to \$3,000 a year, a figure not increased since 1978. This is a bit like the government telling taxpayers, "Heads I win, tails you lose." Gains are always taxable, losses may have to be delayed.

The magnitude of capital gains realizations and taxes in the individual income tax

Long-term capital gains realizations by individuals hit a cyclical peak of \$861 billion in 2007, and fell to \$225 billion in 2009 after the real estate and financial market collapse (table 3). These amounts were 6.1 and 1.6 percent of GDP, respectively. Taxes on long term capital gains ranged from \$122 billion in 2007 to \$28 billion in 2009. The average amount of reported long term gains over the five years 2002–2007, from the business cycle trough to the peak before the housing bubble burst, was \$545.5 billion, or 4.3 percent of GDP, an average of over \$79.5 billion in annual taxes paid. This compares with annual averages of \$933 billion in personal income taxes and \$2.107 trillion in total revenue over the period. The tax on the gains averaged 8.5 percent of total income taxes and 3.8 percent of total revenue.¹¹

Most realized capital gains are subject to tax. Some gains are offset by capital losses, and some limited amounts of gains may be taken against ordinary income, up to \$3,000 a year. Some gains on homes are sheltered, and some gains taken by individuals in the 15 percent tax bracket or below are given a zero tax rate. Many individuals are able to take their capital losses within a few years of their occurrence. Nonetheless, most gains are taxable. Taxpayers do not seem to be able to avoid taxes on gains for long periods. As a result, the average tax rate on capital gains is not significantly below the maximum statutory rate (Auerbach et al., 1997). (See table 3.)

The tax gap

The Treasury periodically estimates a “tax gap,” which is the amount of revenue owed that it fails to collect due to taxpayer non-filing, underreporting, or underpayment. This estimate might offer an upper limit on possible revenue losses due to misapplication of the rate differential.

Underreporting of capital gains on assets receiving a differential tax rate on short- versus long-term gains, such as stocks, bonds, and owner-occupied

11 Historical total revenue and income tax numbers and GDP data from Office of Management and Budget, *Fiscal Year 2014 Historical Tables, Budget of the US Government*, Tables 1.1 and 1.2. <<http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/hist.pdf>>

homes, would appear primarily in the individual income tax non-business income category. However, the bulk of the shortfalls in this category would be due to other factors that make up a larger share of income, such as cash wages and tips not reported or underreported, and other items. The tax shortfall due to the rate differential must therefore be significantly less than this portion of the tax gap estimate. The last such tax gap report was issued for fiscal year 2006.¹² The gross individual income tax non-business income shortfall was estimated at \$68 billion (out of a total gap from all sources of \$450 billion, some of which was recovered by later enforcement efforts). This \$68 billion figure is significantly smaller than the \$456 billion in economic gains associated with a differential tax rate on long term capital gains, as shown in table 1. The fraction of this part of the shortfall attributable to a rate differential would be smaller still. (In addition, realizations and net gains have been noticeably reduced since the pre-recession peak, suggesting even less effect from capital gains.)

Failure to report capital gains, or misconstruing the holding period, is deterred because sales of assets and their holding periods (short term or long term) are reported by brokers and financial institutions on form 1099, copies of which go to the taxpayer and to the IRS. More recently, the IRS has required the financial institutions to include data on the cost basis of the assets sold, where available. The IRS does not identify the specific source of the revenue shortfalls within the broad categories, such as non-business income. However, the comprehensive third party reporting forms for capital gains, plus the larger share of wages and self-employment income in the economy, suggest that the loss of revenue due to misreporting of capital gains is much less than the tax gap totals for individual non-business income.

The magnitude of capital gains and losses in the corporate sector

Capital losses among businesses have been unusually large in recent years, but it appears that they remain in the capital loss category, and are not easily

12 See IRS Statistics of Income Division, Tax Gap “Map,” Tax Year 2006, available at <http://www.irs.gov/pub/newsroom/tax_gap_map_2006.pdf>.

converted into ordinary losses to offset ordinary income. Taxable corporate income rose smartly in 2010 in spite of the increase in unused losses. Although the carry-forward of unused losses expanded hugely from 2009 to 2010, the amounts used in 2010 were smaller than in 2009, and were a very small percent of all losses. The restriction on the use of losses to offset gains appears to be holding up. The various numbers on the magnitudes of gains and losses in IRS data are a bit confusing, but the basic message is that gains and losses are large, and a very large amount are not converted to other forms of income.

In 2009, corporations reported taxable income of \$818 billion on Schedule 1120. They reported *net capital gains* of \$89 billion on schedule 1120. Corporations *with taxable income* (a more limited group than all filers) reported *gross capital gains* from Schedule D of \$46 billion, and *gross losses* from Schedule D of 24 billion. Net losses from exchanges of property were \$20 billion. Businesses were able to use \$26 billion in capital loss carry-forwards against current gains. This was out of \$676 billion in carry-forwards available to all corporations, including those not profitable (up from \$511 billion in 2008).¹³

In 2010, corporations reported taxable income of \$942 billion on Schedule 1120. They reported *net capital gains* of \$76 billion on schedule 1120. Corporations *with taxable income* reported *gross capital gains* from Schedule D of \$75 billion, and *gross losses* from Schedule D of 24 billion. Net gains from exchanges of property were \$17 billion. Businesses were able to use less than \$4 billion in capital loss carry-forwards against current gains, out of a total of \$1.229 trillion in capital loss carry-forwards from 2009 on their 2010 tax returns (up from \$676 billion in 2009).

Reconciling these numbers requires examining Schedule M3. How could gross and net losses be so much less than the rise in the total of unused losses from one year to the next? The line item money accounts published by the IRS Statistics of Income Division show additional capital losses, over \$600 billion in 2010, other than for property exchanges, for all corporations filing returns, *including those without taxable income*. This explains the nearly \$550 billion increase in the unused capital losses from 2009 to 2010. They included

13 Tax return data in these three paragraphs are from Internal Revenue Service, *SOI Tax Stats: Estimated Corporation Data Line Counts*, for schedules 1120 and M3, 2008, 2009, and 2010, available at <<http://www.irs.gov/uac/SOI-Tax-Stats-Estimated-Corporation-Data-Line-Counts>>.

losses in the financial sector associated with the collapse of mortgage-backed bonds and the housing market, and widespread losses due to the last recession. Much of the total loss appears to be attached to businesses that were not profitable. These businesses may never be able to use the losses before they, or the businesses themselves, expire.

Steps the Treasury takes to avoid avoidance

Treasury issues regulations defining capital gains and losses, and proscribing extraordinary financial arrangements that seek to recast ordinary income as capital gains, or capital losses as ordinary losses. New financial planning techniques are continually being developed by business tax planners or accounting firms. The Internal Revenue Service must keep abreast of these efforts. When it finds an arrangement it disagrees with, it may send an automated letter (where software has raised a red flag) asking the taxpayer to review the filing or send additional information. It may send notice that an audit may be needed, or it may conduct an audit to resolve the issue. In many cases, these steps are sufficient to deal with the problem. Where the issue is still ambiguous and the parties cannot reach an agreement, the dispute may go to tax court. On rare occasions when the courts side with the taxpayer due to a shortcoming in the law, Treasury may ask Congress to amend the tax law to make a clear determination that a particular activity is or is not a capital transaction. The Internal Revenue Service is highly experienced in blocking transactions that overstep the boundaries of the regulations.

The IRS budget

Appropriations for the IRS budget under the continuing resolution (CR) for fiscal year 2013 were \$11.888 billion. Of that, \$332 million (3 percent) was spent on business system modernization, \$2.253 billion (19 percent) on taxpayer services, \$3.971 billion (33 percent) on operations support, and \$5.331 billion (45 percent) on enforcement. Full time employment numbers for these areas were 513 (1 percent) for system modernization, 12,240 (14 percent) for operations support, 30,402 (34 percent) for taxpayer services, and 46,702

(52 percent) for enforcement. Within the enforcement area, \$155 million (3 percent) was spent on regulatory efforts, \$611 million (11 percent) on investigations, and the remaining \$4.565 billion (84 percent) was spent on examinations (audits) and collections ([table 4](#)).

For 2014, the IRS requested budget increases of 13.51 percent for operations support, 7.72 percent for taxpayer services, and 6.93 percent for enforcement, and a decrease of 8.9 percent for business systems modification (Department of the Treasury, 2013: 1st and 2nd tables). Enforcement funding is important, and likely to increase revenue collections by several times its budget cost, but it was not at the top of the Service's perceived budget needs.

Enforcement efforts mentioned in the 2014 budget increase request include additional funding for better implementation of enacted legislation, identification of fraud and the prevention of improper refunds (including those due to identity theft), prevention of offshore tax evasion, new reporting requirements to spot underreporting of income, enhanced examination and collection efforts, reduction of noncompliance with special attention to corporate and high-wealth taxpayers, and improved return preparer compliance.

Ordinary examinations and collections take up the bulk of the enforcement budget. These include routine tax return processing, collections, and refunds, as well as random audits and normal monitoring of business returns. Some infractions of the rules relating to capital gains may turn up in these efforts, but it is unclear if they add to the marginal cost of doing the monitoring.

Efforts by the Service relating to investigation, fraud prevention, and regulatory action and reforms to define and preserve the tax base take up about 14 percent of the enforcement budget, or \$766 million. Only a fraction of this investigation and regulatory total can be due to uncovering, exploring, collecting data on, and writing regulations to thwart efforts to create new and more elaborate financial arrangements to evade tax through the manipulation of the capital gains tax differential. These investigation and regulatory amounts certainly pale in comparison to the economic gains from having a capital gains differential (on the order of \$450 billion a year).

Once improper evasion practices are identified, the information is shared with the enforcement division, which can then red flag the tax return features most likely to be associated with the techniques in question. Violations discovered result in collection of the missing tax payments with interest and penalties.

Table 4: Internal Revenue Service program summary by appropriations account and budget activity

Budget activity	FY 2012 Enacted *	FY 2013 annualized CR rate	FY 2014 request	\$ change	Percent change
	(\$ 000s)	(\$ 000s)	(\$ 000s)	(\$ 000s)	(%)
Taxpayer services	2,239,703	2,253,510	2,412,576	172,873	7.72
<i>Pre-filing taxpayer assistance & education</i>	625,189	632,514	660,197	35,008	5.60
<i>Filing and account services</i>	1,614,514	1,620,996	1,752,379	137,865	8.54
Enforcement	5,299,367	5,331,000	5,666,787	367,420	6.93
<i>Investigation</i>	636,386	611,233	661,631	25,245	3.97
<i>Exam & collections</i>	4,504,885	4,565,257	4,842,007	337,122	7.48
<i>Regulatory</i>	158,096	154,510	163,149	5,053	3.20
Operations support	3,947,416	3,971,000	4,480,843	533,427	13.51
<i>Infrastructure</i>	929,634	916,269	939,182	9,548	1.03
<i>Shared services & support</i>	1,214,514	1,239,929	1,305,701	91,187	7.51
<i>Information services</i>	1,803,268	1,814,802	2,235,960	432,692	23.99
Business systems modernization	330,210	332,231	300,827	(29,383)	-8.90
Subtotal, IRS	11,816,696	11,887,741	12,861,033	1,044,337	8.84
<i>Offsetting collections – Reimbursables</i>	122,451	109,193	110,627	(11,824)	-9.66
<i>User fees</i>	326,251	511,425	277,582	(48,669)	-14.92
<i>Recovery from prior years</i>	3,235	439		(3,235)	-100.00
<i>Unobligated balances from prior years</i>	243,266	283,892	113,765	(129,501)	-53.23
<i>Transfers in/out**</i>	193		-5,000	(4,807)	
Total program operating level	12,512,092	12,792,690	13,358,007	845,915	6.76
<i>Direct FTE</i>	91,646	89,857	96,218	4,572	4.99
<i>Other direct FTE 3***</i>	668	21	21	(647)	-96.86
<i>Reimbursable FTE</i>	723	712	712	11	-1.52
<i>User fees FTE</i>	760	965	360	(400)	-52.63
Total FTE	93,797	91,555	97,311	3,514	3.75

Notes: * FY 2012 Enacted represents the approved FY 2012 Operating Plan.

** Resources from Transfers In/Out include a FY 2012 transfer in from the Office of National Drug Control Policy (ONDCP) High Intensity Drug Trafficking Area (HIDTA) Program (\$193K) and a FY 2014 transfer out to the Alcohol and Tobacco Tax and Trade Bureau (TTB) (\$5M).

*** Resources from Other Accounts include Other Direct FTE funded from the Department of Health and Human Services (664 FTE for FY 2012), the Federal Highway Administration (4 FTE in FY 2012, 5 FTE projected for FY 2013 and FY 2014), and Therapeutic Discovery Program Grants and Administration (16 FTE projected in FY 2013 and FY 2014).

Source: Department of the Treasury, 2013.

Senate hearing on a tax planning tool for converting short term gains to long term gains

An example of a Treasury objection to an innovative investment arrangement was explored in a recent Senate hearing. On July 22, 2014, the United States Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs held a hearing, and released a report, entitled *Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits*.

The Treasury is currently reviewing a type of structured financial product called a “basket option” that is, or has been, utilized by a few hedge funds and large banks. Hedge funds are pass-through entities whose investors are taxed under the individual income tax, and who may benefit from the lower tax rate applied to long term capital gains. Treasury has attacked a variant of the device via an IRS Generic Legal Advice Memorandum of November 12, 2010. Some banks have altered the terms of future basket options to meet the objections Treasury listed in the GLAM. Some options issued earlier are still in force.

In the basket options, bundles of financial instruments are purchased and held in the banks’ names. A contract is written in the form of an options agreement, timed to come due after twelve months. In exchange for a premium, about 10 percent of the purchase price, the hedge funds obtain the rights to gains in the portfolio above a certain level. The remaining 90 percent of the outlay is money from the banks, in effect, a loan to the funds. If the option contract is written for a period of more than a year, the profits may appear to be a long term gain, subject to a lower tax rate. The Treasury contends the arrangement improperly transforms short-term trading profits of the hedge funds into long-term gains.

The Treasury contends that, in the offending cases, the assets are effectively controlled, and hence owned, by the hedge fund. The hedge fund dictates the trading of the assets, and is allowed to use the bank’s trading facilities to conduct the trades themselves. Treasury argues that the guarantees and rights of liquidation laid out in the contracts limit the bank’s exposure to adverse price swings, effectively turning the arrangement into loans by the bank and ownership of the assets by the hedge fund. Furthermore, the Treasury complains, the

arrangements are unlike normal options, which reflect the price of a fixed basket of assets: in the plans in question, the asset bundles are frequently altered by thousands of short-term trades in search of trading gains.

The hedge funds stated that the arrangements were not undertaken primarily for tax purposes, and that many of the options were held for longer periods than the twelve months required for long-term tax status. They stated that the object was to obtain increased leverage, as these arrangements face less onerous borrowing restrictions than other types of investment (leverage limits imposed under “systemic risk” regulations following the mortgage bond meltdown and banking system upheaval).

The Subcommittee staff estimated that one of the hedge fund participants avoided \$6 billion in taxes between 2000 and 2013 as a result of the option arrangement, or less than one half billion dollars a year on average. The Congressional hearing gave Senators the opportunity to express their displeasure with the actions of the banks and hedge funds, and to question witnesses from the banks and hedge funds who were asked to testify on the matter. The Senators expressed concern that the Internal Revenue Service may have less authority to audit hedge funds than C corporations.

The lesson from the hearing is not that the tax rate differential makes the system impossible to administer, and that the Treasury may have lost revenue as a result. On the contrary, the lesson to be taken away is that the Treasury quickly noticed the activity and issued an opinion raising the possibility that it would not accord the profits derived from such vehicles a long-term capital gains tax rate. If this were not the case, the Senate would not have been aware of the controversy, and could not have held a hearing.

It is possible that the Treasury or a tax court may ultimately determine that the arrangements met the definition of an option under then-current law and practice, and side with the taxpayers. In that event, it would seem that the lower tax rate was appropriate. If this were to occur, the Treasury could still issue new guidance for what would constitute options contracts going forward, or go to the Congress to ask for a clarification in the law to ban the practice.

Conclusion

The tax treatment of capital gains in the United States reduces the cost of capital and promotes capital formation, wages, and employment. It reduces the anti-saving, anti-investment bias inherent in a broad-based income tax. The capital gains differential adds some complexity to the tax system, and involves some additional enforcement cost. The economic gains from the differential probably exceed the cost of enforcement by a hundred to one. Raising the capital gains tax rate to ordinary income levels would probably yield less revenue, rather than more, for two reasons. First, it would worsen the lock-in effect, slowing the realization of gains, which would cost revenue in the short run, and raise very little, if any, longer term. Second, by reducing GDP, it would shrink the tax base and lower tax collections. The GDP effect by itself would negate any revenue gains. The lock-in effect would only add to the problem.

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About the author

Stephen J. Entin

Stephen J. Entin is a Senior Fellow at the Tax Foundation. Previously, he was President and Executive Director at the Institute for Research on the Economics of Taxation (IRET), a pro-free market economic public policy research organization based in Washington DC. He advised the National Commission on Economic Growth and Tax Reform (the Kemp Commission), assisted in the drafting of the Commission's report, and was the author of several of its support documents.

Mr. Entin is a former Deputy Assistant Secretary for Economic Policy at the Department of the Treasury. He joined the Treasury Department in 1981 with the incoming Reagan Administration. He participated in the preparation of economic forecasts for the President's budgets, and the development of the 1981 tax cuts, including the "tax indexing" provision that keeps tax rates from rising due to inflation. Prior to joining Treasury, Mr. Entin was a staff economist with the Joint Economic Committee of the Congress, where he developed legislation for tax rate reduction and incentives to encourage saving.

Mr. Entin is a graduate of Dartmouth College and received his MA in economics at the University of Chicago, majoring in macroeconomics, monetary policy, and international economics.

Acknowledgements for Capital Gains Tax Reform in Canada: Lessons from Abroad

The editors and authors wish to thank many anonymous reviewers for their helpful comments and suggestions. Any errors, omissions, or mistakes remain the sole responsibility of the authors. As they have worked independently, the views and analysis expressed in this document remain those of the authors and do not necessarily represent the views of the supporters, trustees, or other staff at the Fraser Institute.

About the editors

Charles Lammam

Charles Lammam is Associate Director of Tax and Fiscal Policy at the Fraser Institute. Since joining the Institute, Mr. Lammam has published over 35 peer-reviewed studies and 150 original commentaries on a wide range of economic policy issues including taxation, government finances, pensions, investment, income mobility, labour, entrepreneurship, public-private partnerships, and charitable giving. His commentaries have appeared in every major national and regional newspaper in Canada (including the *Globe and Mail* and *National Post*) as well as prominent US-based publications (including *Forbes* and *The American*). Mr. Lammam regularly gives presentations to various groups, comments in print media, and appears on radio and television broadcasts across the country to discuss the Institute's research. He has appeared before committees of the House of Commons as an expert witness. Mr. Lammam holds an M.A. in public policy and a B.A. in economics with a minor in business administration from Simon Fraser University.

Jason Clemens

Jason Clemens is the Fraser Institute's Executive Vice-President. He held a number of positions with the Fraser Institute between 1996 and 2008, including Director of Research Quality, Director of Budgeting and Strategic Planning, and Director of Fiscal Studies. He most recently worked with the Ottawa-based Macdonald-Laurier Institute (MLI) as Director of Research and held a similar position with the San Francisco-based Pacific Research Institute for over three years. Mr. Clemens has an Honours Bachelors Degree of Commerce and a Masters Degree in Business Administration from the

University of Windsor as well as a Post-Baccalaureate Degree in Economics from Simon Fraser University. He has published over 70 major studies on a wide range of topics, including taxation, government spending, labour market regulation, banking, welfare reform, health care, productivity, and entrepreneurship. He has published nearly 300 shorter articles, which have appeared in such newspapers as the *Wall Street Journal*, *Investors' Business Daily*, *Washington Post*, *Globe and Mail*, *National Post*, and a host of other US, Canadian, and international newspapers. In 2012, the Governor General of Canada, on behalf of Her Majesty the Queen, presented Mr. Clemens with the Queen Elizabeth II Diamond Jubilee Medal in recognition of his contributions to the country.

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Date of issue November 2014

ISBN 978-0-88975-325-9

Citation Charles Lamman and Jason Clemens (eds.) (2014). *Capital Gains Tax Reform in Canada: Lessons from Abroad*. Fraser Institute.

Cover design Monica Thomas, Foothills Graphics

Cover illustration Global Map © Illustrious, iStock

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