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Capital gains in Canada.

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CAPITAL GAINS IN CANADA

by

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ABSTRACT

This thesis deals with the capital gains question in Canada. In the process of evaluating the present tax status of capital gains an attempt is made to clarify the concept of capital gains by examining its historical origin and the accounting, legal and economic meaning of the term.

The evaluation of the present tax status of capital gains is based on consideration of economic effects, administrative feasibility and demands of horizontal and vertical equity.

For lack of sufficient empirical data a definite stand has to be avoided concerning the probable economic effects of a full income inclusion of capital gains and losses. The result of this procedure is that important aspects concerning the taxation of capital gains are not considered.

The problems involved in taxing capital gains are considerable and require practical solutions before proceeding with any suggested implementation of a capital gains tax. U.S. experience would indicate that problems of administering a capital gains tax are not insurmountable.

It would appear that on the basis of equity the

preferential treatment of capital gains is neither necessary nor desirable and the full inclusion of capital gains in ordinary income would increase opportunities for equalizing the tax treatment of gains and ordinary income. The recommendations of the Carter Royal Commission Reportrregarding capital gains concur with the conclusion that the present system of exempting capital gains completely from taxation is inconsistent with the demand of an equitable distribution of the tax burden.

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INTRODUCTION

The tax treatment of capital gains in Canada is characterized by a long history of disputes, controversy and misunderstanding. The seemingly endless flow of heated debate concerning the taxibility of capital gains which has appeared with increasing frequency not only in learned journals, but in popular magazines and newspapers as well, serves to support the view that the tax treatment of capital gains is very much a topic of current public concern.

Much of the capital gains tax debate deals with the economic effects of a capital gains tax on incentives to save and invest, particularly through the purchases of corporate securities. Opinions on these effects differ widely among economists. Some, like Robert F. Gemmil and Walter W. Heller, recommend the full taxation of capital gains at regular rates, while others, like Dan T. Smith and Harold M. Somers, feel that the capital gains tax is unfair and economically harmful and that the mobility of investment funds is hampered by the gains tax. It should be noted that the views of Walter W. Heller and Robert F. Gemmil agree with the recommendations of the Carter Royal Commission Report regarding the tax treatment of capital gains.

The object and approach of this study is to critically evaluate the present tax treatment of capital gains in Canada. The procedure followed in developing the necessary criteria of evaluation consists of an examination of the historical, accounting, legal and economic aspects of the capital gains issue. Further, in considering the economic effects of capital gains taxation, attention is focused on the effects of the tax on resource allocation, on dividend policy, on resource mobility, on the locked in effect, on speculation and gambling, and consideration is given to the likely effects of anticipated changes in the treatment of capital gains. The important distinction between real and nominal capital gains is highlighted. The present tax treatment of capital gains is evaluated in the light of horizontal and vertical equity principles. This evaluation of the capital gains tax from the point of view of equity leads to the conclusion that arguments against the capital gains tax on equity grounds are unsupportable and that the present tax treatment of capital gains is biased, inequitable and inefficient.

CHAPTER I

HISTORY OF CAPITAL GAINS

From early times capital gains were not considered as income primarily due to their non-recurring or irregular nature. The concept of capital gains can be traced back at least as far as the Germanic invasions of the Western provinces of the Roman Empire, including Western Europe and present day England. The lords and leaders of these invading tribes acquired large holdings of land, thus giving birth to the large landed estates of England and Western Europe. The law of primogeniture and the introduction of entails prevented the property from being divided into small parcels by succession or alienation. The heir was generally required to refrain from impairing the principal, although he could enjoy the income or fruit of his estate during his lifetime.

Historically, the courts rendered decisions regarding capital gains based on the distinction between principal and income. The ownership of such land amounted to no more than a life tenancy and any appreciation in value of the land could not be considered the heir's rightful income, irrespective of the general restraint on his right to alienate or realize such a gain.

Since the estates of post-feudal Europe were generally entailed, a man's wealth was better measured by his income than by the capital value of the property from which he drew it. The kind of income that was significant for this purpose was the income that could be expected with a reasonable degree of certainty. It was the regularly recurring income and not the unforeseen, extraneous, unexpected or sporadic receipts that mattered. Traditionally, a man's economic position in England and Western Europe came to be viewed in terms of his regularly recurring annual income and not by the capital value of his estate.

It became socially acceptable through hundreds of years of custom and tradition to regard landed estates as "things" (res) rather than "pecuniary values" (quantum). It follows from this that fluctuations in value of the (res) estate do not constitute income and therefore any such realized value increments are considered to be additions to capital.

It is not surprising, therefore, to note that English Courts have drawn a parallel between land and its fruit or harvest and between fixed capital and the products produced by its use, particularly in the light of Adam Smith's clear distinction between circulating and fixed capital. The emphasis on this distinction still prevails. The profit and loss account, according to contemporary accounting theory, intends to show only the results from ordinary operations during the year and does not reflect either the realized or unrealized capital gains or capital losses.

When Great Britain inaugurated income taxation in 1798 and when the present income tax system came into effect, the law of income tax made a clear distinction between the concept of income and capital gains. Consistent with the "res" concept of an investment, capital gains were excluded. Historically, there are other reasons why the idea of income as a regularly recurring phenomenon has been impressed on the minds of the British. The relatively rigid economic structure of society in England provided large numbers of persons with relatively fixed incomes, both in terms of regularity of receipts as well as in terms of its source, hence capital assest changed hands only infrequently. Consequently, the idea of non-income increments to capital came to be sharply distinguished from the regularly-recurring-receipt concept of income.

The economic concepts concerning capital gains in Canada during the eighteenth and nineteenth centuries were largely based on the nature of agricultural income. Early Canada, with a predominantly agricultural economy, came to see income as a physical fact of nature consisting of an annually recurring harvest as distinguished from the physical fact of capital consisting mainly of land.

Many of the early settlers came from England, France and Western Europe where the doctrine of capital gains originated. The educated were no doubt influenced by the teachings of Adam Smith[1] and had gone to English or West European universities. On the practical level, the oldest professional accounting body was the Scottish Institute of Chartered Accountants, whose members became Canada's first accounting practitioners, thus opening a direct route of influence of English economic thought on Canadian business. It was held that like the annual harvest, income accrues regularly and in recurring fashion over time, as a result of deliberate economic activity. The idea of income as a regularly recurring harvest, distinct from the land that produced it and emanating from purposeful economic activity, the fruit of which can be consumed without impairing the source of that income, can be traced to the agrarian character of early English and Canadian economic life. The idea was that the most important characteristic of income was its tendency to recur at more or less regular intervals.

Many of these ideas found their way into everyday business through the accounting profession. For example, H. A. Finney, as early as 1921 made the strong recommendation that gains and losses on disposal of fixed assets should be reflected in a "capital surplus" account rather than in the "general surplus" account which he considered the proper resting place for regularly recurring earned-

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[1]Adam Smith, The Wealth of Nations. (New York: E. P. Dutton & Co., Inc., 1937).

profits.[2] It appears that at the turn of the century, the majority of accounting writers believed that realized gains on disposal of capital assets should be credited to a capital surplus rather than an income account.[3]

In the late nineteenth century, while business was rapidly expanding and railroads were stretching westward, a new development took place. The major opportunity of gain in this period was not in obtaining a share of the firms' regular income but in obtaining a capital gain. Farmers and immigrants moving westward would purchase land at a low price and resell at a gain to the railroads. It came to be recognized that many fortunes were built through realized capital appreciation rather than by income yielded through the use of such capital assets. This development led to some disagreement and doubt among the orthodox regarding the nature of capital gains, and the view that realized capital gains constitute a form of income came to be voiced more frequently by some prominent persons in courts, business and the accounting profession.[4]

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[2]H. A. Finney, "Students' Department," The Journal of Accounting, (May, 1921) and
H. A. Finney, Principles of Accounting (New York: Prentice-Hall, Inc., 1923).

[3]Robert H. Montgomery, Auditing Theory and Practice (New York: The Roland Press Company, 1927).

[4]Lawrence H. Seltzer, The Nature and Tax Treatments of Capital Gains and Losses (New York: National Bureau of Economic Research, Inc., 1951).

In conclusion, it can be stated that the clear cut nineteenth century concepts regarding the nature of capital and income came under serious attack through the historical experience of railroad building and westward expansion in early Canada. This dichotomy between the "orthodox" and the "new" views on the nature of capital and income, constitutes an important aspect of this study.

CHAPTER II

CONCEPTS OF CAPITAL GAINS

A. The Accounting Concept of Capital Gains

This is to clarify the accounting usage of the terms "income" and "capital gain" and to provide a basis for comparison with the legal and economic interpretations of the concepts. In accounting there are two main schools of thought concerning capital gains, the all-inclusive versus current operating performance concepts. While accountants are generally in agreement as to the basic concepts regarding the nature and measurement of the total income of a business entity there is some disagreement in the application of these basic concepts in the determination of periodic net income. Specifically, a controversy exists as to whether certain material items of gain or loss, i.e. extraordinary and non-recurring items should appear only in retained earnings or be disclosed only in the income statement. The American Institute of Accountants (Accounting Research Bulletin No. 43) favours the current operating performance concept while the American Accounting Association in The "Accounting Concepts Underlying Corporate Financial Statements", expresses a preference for the all-inclusive concept. The Security Exchange Commission also favours the all-inclusive concept in Regulation S-X, 1956. This may partly explain the current trend in accounting to clarify the disclosure of capital gains and losses in financial statements and to adequately explain the nature and origin of the items involved.

Furthermore, the accounting convention of not recognizing capital gains until they are actually realized raises the problem of proper accounting treatment for non-recurring cash items. The main problem appears to be one of conceptual clarification of income, measurement and the timing of recognition and disclosure.[4] The essential criterion of income for accountancy is an asset[5] increase arising from income-producing activities. It, therefore, makes little difference whether such activities are unusual, extraordinary and non-recurring or whether they are normal, expected and planned.

Income results from the diminution of assets in an attempt to derive increased assets. The various criteria of income in accountancy have in common the essential characteristic of an increase in total assets. Essentially, therefore, income is strictly an asset concept in the eyes of accountancy. It appears, however, that the so-called criteria of income determination in accountancy are in fact more closely concerned with reporting standards, than with an examination of what constitutes income. Recognition is

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[4]Joel Dean, "Measurement of Profits for Executive Decisions," The Accounting Review, (April, 1951) pp. 188-190.

[5]A physical property or intangible right, owned by a business or an individual, that has a value in exchange.

given to the fact that the source of the assets concerned is immaterial from an income-determination point of view, that the results of business activity are never fully guaranteed, irrespective of whether they are "extraordinary" or "usual" and that some modicum of "effort" must be exerted to carry through any transaction.

The accounting approach has typically been more pragmatic than that of economics and, therefore, it is not surprising to find the accounting perspective focusing more on the effects and consequences of various reporting standards and modes of disclosure, than on the nature of income.

Accountancy is concerned with providing accurate and objective reports of financial position and the results of operations to potential users. The variety of interested parties and their relative importance influences the mode of classification, presentation and disclosure on financial statements. The various users of financial statements require a need for a break-down of income as to source, in order to make decisions regarding solutions to their particular problems. Income tax authorities only tax income from certain sources. Recurring income items are of greater interest to present or potential investors and creditors than non-recurring items, since such a classification provides a more accurate guide to prognostication concerning the future.[6] Management, on the other hand, is more concerned

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[6] Audits of Corporate Accounts (Correspondence between the Special Committee on Co-operation with Stock Exchanges of the American Institute of Certified Public Accountants and the Committee Stock List of the New York Stock Exchange, 1932-33) pp. 10-12.

with the result of its planned activities, rather than with the relative frequency of occurrence of various income generating events. A comparison of current activities with past results of operations almost invariably indicate discrepancies, which could conceivably be used to stretch the meaning of capital gains or losses to an absurd extent by labelling these discrepancies as "unusual," "extraordinary" or "unexpected." However, the discrepancies may be indicative of fluctuations in demand which, although at first unexpected, may indicate the beginning of a consistent trend. Perhaps these discrepancies could be viewed as "unusual" or "extraordinary" if seen merely as a point in time. Viewed in perspective over a period of several years or decades, such "extraordinary," "unusual" events might easily assume the nature of a short-run or long-run trend. Thus, a dynamic view of the business process poses the perturbing question as to how many times can an event occur or for how long may it persist before it becomes "normal" and "recurring."

Such occurences as demand fluctuations, changes in consumer tastes and preferences, the beginning of a recession or that a competitor is becoming more successful, are all potentially "unusual" or "non-recurring" events, but may nevertheless extend over a period of time, making them "normal," "usual" and "expected" if viewed in dynamic perspective.[7]

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[7]Edmund Whittaker, Economic Analysis (New York: John Wiley and Sons, Inc., 1956), pp. 90-94.

The meaning of the term "income" depends upon the use to which it is put, the point of view taken and the time period emphasized. "Different groups have different concepts of business income,"[8] as documented by the Study Group on Business Income, sponsored by the Rockefeller Foundation. That its report did not arrive at a uniform definition of business income[9] is understandable when it is realized that within the accounting profession itself there has been no unanimous agreement on terminology employed in, and the form of, the income statement.[10]

Most disagreements among accountants regarding the concept of income stem from the differing viewpoint each takes. Those emphasizing data required for short-run managerial decisions may emphasize direct costing methods, while others concerned with the allocation of resources, national income statistics and the like, may emphasize replacement values or values adjusted for changes in the general purchasing power of the dollar. Thus the methods

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[8] Rufus Wixon, Accountants' Handbook (New York: Ronald Press Co., 1956), 4th edition, chapter I, p. 19.

Charles E. Johnson, The Concept and Measurement of Business Income for Corporate Reporting (Ph.D. Thesis, University of Minnesota, 1952)

Robert B. Bangs, "The Definition and Measurement of Income," Accounting Review, XV (September 1940), 371.

[9] Study Group on Business Income, Changing Concepts of Business Income, Report (New York, Macmillan Co., 1952).

[10] Wixon, op. cit., p. 19.

of income determination in accountancy are governed by the practical requirements of the various categories of users of financial statements.

> One of the most controversial subjects in recent years concerns the classification of so-called extraordinary gains or losses in the income statement. Some accountants favour the all-inclusive income statement while others favour the current operating performance type of income statement. Both forms are found in use today. The settling of such controversies would remove some of the confusion as to what constitutes income.[11]

It should be recognized, however, that the views expressed in this chapter do not necessarily represent the consensus of informed opinion since accounting principles are actually heterogeneous in origin and frequently vague and contradictory. They represent an admixture of rules, conventions and procedural guides that are often based upon practical rather than sound conceptual considerations.[12]

B. The Legal Concept of Capital Gains

The capital gains concept and its immunity from tax as adopted by Canadian Courts stems from English Income Tax Law. The Canadian Income Tax Act[13] does not define

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[11]Wixon, *op. cit.*, p. 19.

[12]Morton Backer, "Determination and Measurement of Business Income by Accountants," in Morton Backer (ed.) *Handbook of Modern Accounting Theory* (New York: Prentice-Hall Inc., 1955), p. 212.

W. A. Patton and A. C. Littleton, *An Introduction to Corporate Accounting Standards* (Chicago: American Accounting Association, 1940), p. 21.

[13]*Revised Statues of Canada 1952*, Chapter 148 (Ottawa: Queen's Printer, 1967).

the term "capital gain" nor, for that matter, the word "income." The Act does, however, bring within income for tax purposes all income from business and property and it indicates that the income from "a business or property is the profit therefrom for the year."[14] Business is defined in the Act as including "a profession, calling, trade, manufacture or undertaking of any kind whatsoever" and it embraces "an adventure or concern in the nature of trade."[15] A non-taxable capital gain, simply put, is a gain made on the realization of an investment rather than in carrying on of a business or "an adventure in the nature of trade."[16] This statement has been accepted as expressing the authoritative distinction between income and capital gain by the English House of Lords,[17] the Juducial Committee of the Privy Council[18] and the Supreme Court of Canada.[19]

"Investment" is not defined in the Act. Generally speaking, the term suggests acquisition of property, other than property used in business, such as real estate or securities to be held on a more or less permanent basis and

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[14] Ibid.

[15] Ibid., Section 139.

[16] Ibid., Section 139 (1) (a).

[17] Decker V. Rees Roturbo Development Syndicate Ltd. (1928), Appeal Court 132. As described in DTC, CCh Canadian Limited.

[18] Commissioner of Taxes V. Melbourne Trust Ltd.(1914) Appeal Court 1001.

[19] Campbell V. M.N.R., (1953), S.C.R. 3, 52 DTC 1187.

on which a return of income is expected.[20] The Tax Appeal Board and the Courts look at the taxpayer's whole course of conduct not only for the period under appeal, but also his conduct for the period under consideration in determining whether a return is a capital gain.[21]

In examining the taxpayer's course of conduct the following factors have usually been taken into consideration by the courts: whether the transaction was expected, controllable, recurring, and the ordinary and main function of the person or whether it bore the earmarks of a capital gain by being unexpected, uncontrollable, non-recurring and extraordinary and ancillary to the main objects of the party in question. In other words, the principal legal requirement that the taxpayer have no intention to make a profit is evaluated in the light of the above cirteria. The transaction under scrutiny is examined to ascertain its degree of relationship to the taxpayer's regular business, the nature of the transaction and the type of asset being disposed, the nature of improvements to the asset that make it more valuable or more readily marketable and the number and frequency of such transactions.

Since the Act fails to define either capital gains or income in a clear and unequivocal manner, it is not surprising that much of the work of determining taxable income has

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[20] McLennan v. Minister of National Revenue DTC 184.

[21] Rosenblat v. Minister of National Revenue DTC 184.

fallen to the courts. The distinction between capital and income receipts has provided a vast source of litigation. Since capital gains are treated in the Canadian Income Tax Act as a residual, after all income receipts, it is the definition of income to which one must look for illumination. The interpretative work of the courts centers around the concept of "an adventure in the nature of trade" as per section 139 (1) (a) of the Act. This term which was borrowed from Britain and was first used in 1948, has proved to be perplexing. It is apparent from an examination of many of the cases that have arisen concerning its meaning, that it is a difficult concept to define. While a number of tests have been devised to determine its meaning, in the final analysis each case is decided on the basis of its own facts with the tests serving merely as a rough guide.

"It has frequently been stated in the courts that a case is only an authority for what it actually decides -- and in relation to its particular facts."[22] In Rex v. Harevslak, (1937), I. D.L.R. 337, at 343, the following quote illustrates the typical judicial attitude:

> The finding arrived at in the present appeal should thus not be interpreted as indicating that in no case similar to this one could a taxpayer be found to be in business of buying and selling real estate. Nothing could be farther from the truth.

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[22] Baryk, Harry J. v. Minister of National Revenue (4. A.B.C. 329). (as per DTC, CCH Canadian, 1967).

One, therefor,e faces the frustrating experience of being told that in the final analysis the determination of whether a capital gain has been made or not, is a question of fact, and in no sense a question of law. In decisions favourable to the taxpayer, the public is warned that a slight change in circumstances might prompt the tribunal to arrive at a different conclusion. This situation urgently calls for fromulation of legal principles which would be applicable to all cases in order to provide some guide for taxpayers' conduct. Thus we arrive at the conclusion that even judicial decisions do not insure future certainty of interpretation because they are also subject to reinterpretation by subsequent courts; and depending on the circumstances, they may be construed as widely or narrowly as the statute itself.[23] In some instances, a decision has been subsequently applied only in a virtually identical situation.

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[23] J. Harvey, Perry, Taxation in Canada, University of Toronto Press, 1961.

F. E. LaBrie, The Meaning of Income in the Law of Income Tax, Toronto: University of Toronto Press, 1957.

W. G. Leonard, Canadian Income Tax for Accountants, 4th edition, C.C.H. Canadian Limited, 1963, Chapter 2.

Canadian Master Tax Guide, 22nd edition, C.C.H. Canadian Limited, 1967.

Canadian Income Tax Act, op. cit.

H. Hewart Stikeman, Q. C. Income Tax Act (Toronto: Richard DeBoo Limited, 1967).

C. The Economic Nature of Capital Gains

The economic nature of capital gains must be ascertained before consideration is given to the question of whether it is a proper subject of taxation and if so, what the nature of such taxation ought to be. Our analysis of the taxation of capital gains requires a clarification of the question concerning the nature of income, and more particularly, whether capital gains can be properly classed as income or some species thereof. Since economists fail to agree on the meaning of income, the answer to the question of what constitutes a capital gain depends on the choice of our definition of income.

1) The Nature of Income

Economists disagree on the question of whether capital gains are a form of income or not. George Schantz defines income as including all profits, benefits, valuable services, gifts, inheritances, legacies, lottery winnings, insurance annuities and speculative gains.[24] The answer to the question of whether capital gains are a form of income depends on the definition of income accepted. The view that there is no basic difference between capital gains and ordinary income is supported by I. J. Goffman, Robert Murray Haig

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[24] Paul H. Wueller, The Integration of the German Tax System (New York: Columbia University Press, 1933).

and Professor Henry C. Simons.[25] John F. Due advances two alternative definitions, consumption-plus-increase-in-net-worth and flow-of-wealth and suggests that capital gains, may fall within either category, as long as they do not merely represent price level increases.[26] Due accepts the view that only realized gains can be taxed, but fails to analyse reasons for or against that view. William H. Anderson expresses qualified acceptance of the income view of gains, stating that gains do not add to the flow of goods and services for the individual taxpayer, and that they do not increase his satisfaction unless or until they are realized at which time they do command goods and services.[27] Dan Throop Smith refuses to accept Due's concept of income as consumption-plus-net-increase-in-wealth. He claims that the recipient of a capital gain cannot consume such proceeds without impairing the integrity of his capital.[28]

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[25]I. J. Goffman, "The Taxation of Capital Gains: An Economic Analysis," The Canadian Journal of Economics and Political Science, XXVIII, (May, 1962), pp. 323-238, and Robert Murray Haig, "The Concept of Income," The Federal Income Tax, ed. R. M. Haig (New York: 1921)

[26]John F. Due, Government Finance: An Economic Analysis (rev. edition; Homewood, Ill.: Richard D. Irwin, Inc., 1959).

[27]William H. Anderson, Taxation and the American Economy: An Economic, Legal and Administrative Analysis (New York: Prentice-Hall, Inc., 1951), pp. 208-212.

[28]Dan Throop Smith, Federal Tax Reform: The Issues and a Program (New York: McGraw-Hill Book Co., Inc., 1961), pp. 120-22.

Those economists who hold views similar to those of Smith, propose tax exemptions for capital gains on grounds that they are not income. They base their agrument on the view that income is what an individual can spend without impairing his capital. In this view, income and capital are regarded as distinct concepts and the distinction is frequently illustrated by the tree-fruit analogy, wherein a crop of apples is income while the growth of the tree is capital appreciation. The conclusion arrived at by Smith, based on the apple-tree dialogue is entirely different from Stanley Surrey's approach to the definition of income. Surrey maintains that capital gains increase economic well-being and, therefore, should be taxed.

It seems pertinent to emphasize that the answer to the question of whether capital gains should be taxed depends on the choice of the definition of income. The lack of agreement among economists on the meaning of income, lies at the core of uncertainty and confusion concerning the taxability of capital gains. If the chosen concept of income is sufficiently broad to incorporate all elements of capital appreciation, then it would seem that on the basis of equity alone capital gains would have to be fully taxed at regular rates. In actual practice the concept of income chosen depends on whether such data are to be used by owners, creditors, potential investors or the Department of National Revenue. It is clear, therefore, that conventions of everyday practice contribute little, if anything, to the clarification of the meaning of income.

2) Characteristic Qualities of Capital Gains

There are generally two modes of classifying capital gains; either in terms of the way the gain arises or in terms of the type of asset concerned. In a broad economic sense a capital asset is any asset or property held for further production of wealth or as a source of income. This defines the source from which the gain is derived. Distinction between regular stock-in-trade or inventory for resale and other types of income producing assets is a further refinement of the definition of capital assets.

The unexpected nature of capital gains is important, but the question arises as to the realistic extent to which gains can be deemed unexpected in a milieu of highly developed markets. Markets for capital assets are large, well organized and embedded in a technological setting characterized by extremely rapid, detailed and accurate transmission of information. Within such highly developed and smoothly functioning markets the likelihood of a truly unexpected gain diminishes and with it vanishes the likelihood of realizing genuine windfall gains characterized by their unexpected nature. It seems difficult to imagine any but the most naive of investors who would fail to consider the possibility of some appreciation or decline in value of his holdings over a period of time. While a capital gain may not be the prime motive of a transaction, it nevertheless, remains one of the probable motives in a large number of cases and, therefore, the additional requirement that capital gains be unsought after makes the likelihood of their realization difficult if not impossible.

Capital gains can be characterized as being unexpected and unsought after and should involve capital assets.[29] Such gains being both irregular and unusual occur outside the annual course of earning one's income. The requirement that capital gains have an unexpected and unsought after quality makes their realization unlikely in the modern world of organized markets. In national income accounting, only the net value of final goods and services produced in a given year are considered; taking into account only the current product of deliberate economic activity. Such accidental additions and subtractions to the stock of national wealth as new resource discoveries or destruction by floods and hurricanes are excluded from the annual income flow on the theory that they are not the result of regular productive activity. Although, capital gains are generally regarded as unforseen increments in the real value

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[29] A. C. Pigou, A Study in Public Finance, Third and revised edition (London: Macmillan Co., 1949), p. 156; J. R. Hicks, Value and Capital (Oxford: Clarendon Press, 1939) XIV; Gunnar Myrdal, Monetary Equilibrium (London: London University Press, 1939), pp. 59-62; John M. Keynes, The General Theory of Employment, Interest and Money (New York: Harcourt, Brace and Company, 1936), pp. 52-61.

of previously existing capital assets not directly attributable to effort, intelligence, capital or risk taking, cogent arguments exist for the view that capital gains are conceptually identical with income. To evaluate the validity of this view requires a closer look at what occurrences underlie the realization of additions in real value of capital assets.

Capital gains may arise in several ways. As suggested by Seltzer, three types of changes give rise to capital gains. The first of these concerns a change in the future stream of income flow. The typical investor will estimate his expected income and weigh his expectation on the basis of the probability of recognizing each of the several annuities concerned. The investor arrives at the present value of the capital asset by discounting the expected income at a rate of return which he expects. The possibility of large gains or losses and the degree of likelihood of their materialization will enter the choice of the rate of return expected and in the case of readily reproducible assets, their cost of production will set the upper limit to the present cost of the asset.

Secondly, since interest yields vary inversely with the value of the asset, interest rate changes affect values of interest-bearing assets. Interest rate fluctuations also influence the desired rate of return used in discounting future income streams to arrive at their present value.

The third change involves the investor's inclination to face uncertainty. The higher the degree of risk involved in receiving the expected future income, the higher the expected rate of return in compensation for undertaking the additional burden of uncertainty. Changes in compensation to induce investors to assume risk affects asset prices through the effect on the expected discount rate.[30]

The brief survey of economic opinion concerning the meaning of income and capital gains leads to the uneasy conclusion that the question concerning the tax treatment of capital gains depends on the definition of the concept of income which we choose to adopt.

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[30] L. H. Seltzer, op. cit.

CHAPTER III

CERTAIN ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION

A. Effects on Resource Allocation

One of the criteria on which a tax or proposed tax should be evaluated is its effects on the economy. This chapter is devoted to an analysis of the effects of capital gains taxation on resource allocation. What effect will such a tax have on the flow of funds into the stockmarket and other high risk ventures including speculative real estate development? The critics of the tax assert that imposition of a capital gains tax will not only deter the availability and flow of funds into these areas of endeavour but will also immobilize those funds which have been committed. How this comes about and why are questions deserving of an answer.

It is claimed that the tax will deter investors from liquidating their holdings because it will reduce their net worth and cause a loss of future income. This is known as the "locked-in" effect of the capital gains tax. Reluctance to pay tax on the realized gains leads to resource immobility as investors will hesitate to dispose of their assets when purely economic considerations might prompt such a move.[1]

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[1]C. C. Holt and J. P. Skelton "The Locked-in Effect of the Capital Gains Tax," National Tax Journal, XV (December 1962), pp. 337-352.

The counter argument maintains that it is unnecessary to provide incentives other than those of a purely economic nature for the purchase and sale of existing assets; and that therefore, capital gains should be taxed fully as income. In reply, it is argued, that in the interest of economic growth, investment in new capital goods should be encouraged by preferential tax treatment of capital gains. It is worth noting, however, that acquisitions of outstanding securities and existing assets, are not investments from a social point of view.[2] If the intention of favoūrable tax treatment of capital gains is to provide incentives to economic growth, it hardly appears justifiable to extend the privilege to those purchasing existing assets.

The counter argument claims that the tax exempt nature of capital gains permits the withdrawal fo funds from existing assets and their utilization in the creation of new ones and that the imposition of a tax would hinder the smooth flow and possible transfer of funds on the stock-market from the old established and seasoned securities into capital intensive ventures of promise.[3] It is impossible to determine what effect an exchange of existing securities and assets will have on the economy in the absence of in

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[2]Raymond L. Richman, "Reconsideration of the Capital Gains Tax - A Comment," National Tax Journal, XI (December, 1961), pp. 403-404.

[3]Kenyon F. Poole, Public Finance and Economic Welfare (New York: Rinehart and Company, Inc., 1956), pp. 198-200.

information regarding how investors would use their funds if disposal of their assets were frozen by an imposition of a capital gains tax. The entire discussion of the effects of a capital gains tax on economic efficiency and resource allocation is a matter of conjecture, to say the least.

It appears that a tax which hinders the free transfer of existing assets would be undesirable, since liquidity in asset and security markets is necessary for the free and unhindered flow of funds from savers to investors and vice versa. The question, which to a considerable degree remains unanswered, is whether the imposition of a capital gains tax would in fact hinder the free transfer of existing assets. Once again, in the absence of empirical information, the reply must be speculative. Does a capital gains tax provide a deterrent to a liquid asset and security market? Empirical evidence on this point is difficult to compile and since little of it is available, an attempt will be made to answer this querry by examining the investment motivation of the market.

The average investor may be assumed to be interested in both income and capital appreciation and there should be nothing about a tax on capital gains to discourage asset acquisition even if the primary purpose of the transaction is the realization of a capital gain. The effect of the tax is to lower the rate of return on certain investments. The critical point comes when the tax reduces the net rate of return below that which a particular investor believes necessary to induce him to invest rather than to hold his assets in a more liquid form. If the rate of tax is so high as to discourage further investment, it would seem that a decrease in the rate rather than a complete elimination of the tax would be called for.

While a capital gains tax would most likely cause little interference with the aggregate volume of investment, it may substantially alter the nature of the investments made. At present, investment is diverted into ventures accorded preferential tax treatment by law, without regard to the pure economic yield of the project. Since the lucrativeness of alternative ventures is evaluated on the basis of after-tax rate of return, the resultant evaluation of alternative projects will not be based on their real return to the economy, but on their distorted net returns after taxes as induced by legal stipulations concerning the eligibility of the receipt as a capital gain. Excess investment could conceivably take place in those areas in which transactions produce the desired rates of return under present tax-exempt conditions for capital gains.

It would appear that even a preferential tax on capital gains causes distortions of investment and misallocation of resources with resultant over and underinvestment over wide areas of the economy. The further obvious disadvantage of preferential tax treatment consists of the real costs of tax avoidance which must be deducted from any gains that can be attributed to preferential taxation. Tax benefits can be purchased for a price. If capital gains were to be taxed at regular rates, the energies and talents of thousands of lawyers, accountants and notaries, presently engaged in the romantic occupation of arranging transactions in the legally required form, would be freed and presumably made available for directly productive functions by increasing cost accounting efficiency and by genuinely enhancing the efficiency of production processes. It would seem that the sum of private tax compliance costs paid to accountants, lawyers, and the amount spent by the government on tax investigation and enforcement would constitute a socially significant saving.[4]

B. Real Capital Gains v. Nominal Capital Gains

The changing values of assets can be broken down into two categories; namely, into changes due to a change in the value of the dollar as a medium of exchange or a general price level change, and movements in the specific price levels of individual assets. The difficulty of distinguishing and measuring the effects of these two distinct forces behind capital gains, cannot be overemphasized. It becomes clear

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[4]Although data regarding actual or estimated dollar costs involved are not available, the above conclusion flows naturally from the opportunity cost theory and the writer's personal experience as an employee of the Department of National Revenue.

then that capital gains brought about by changes in the general price level cannot be separated from those capital gains which are brought about by changes in the supply and demand for specific assets.

> Capital gains which result because of price level changes are in the economic sense not gains at all but merely measures of the declining purchasing power of the monetary unit. ...In a period of rising prices, there is an element of capital gain in every sale of a product the cost of which includes an element of depreciation based on original cost. In computing the amount of income tax payable, the capital gain element in so-called operating income, in theory, should be separated out and taxed on the lower basis permitted by law.[5]

The imposition of a capital gains tax on that portion of asset appreciation which is attributable to the changing value of the dollar raises serious problems in the area of resource allocation. The problem exists by virtue of the fact that a substantial proportion of assets used by business enterprises in their processes of production are long-lived. Consequently, as the costs of these assets are depreciated over their useful lives (or at rates permitted by The Income Tax Act) in either a period of inflation or deflation, the result is the matching of these historic dollars of given purchasing power in the year of acquisition with current dollars of quite different purchasing power. The net result of this situation is that the "dollar" profits shown on financial statements are incorrect from the point

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[5]Oscar S. Nelson, "Capital Gains from Price Level Increases," The Accounting Review, (January, 1951), pp. 31-32.

of view of economic profit. The accounting conventions used in arriving at so-called net income fail to distinguish between the purchasing power of dollars in various years and proceed to allocate historic costs against present revenue on the assumption of constancy in the purchasing power of the dollar. Consequently, during a period of years characterized by a more or less consistent trend of inflation, the profits of businesses have been systematically overstated. Since the profit figure serves not merely as a criterion of performance but also as a basis for vital and diverse decisions, management policies ranging from investment to dividend payments, have been correspondingly distorted. To the extent that these decisions were based on erroneous data, resources so affected were inefficiently allocated.

A further misallocation of resources is attributable to the "hidden" taxing of business capital which leads to a gradual erosion of the productive resources. Specifically, in periods of inflation, firms with large investments in plant and equipment are discriminated against. This takes place because the sum of their annual depreciation charges is inadequate to provide for the replacement of the worn out assets at current prices.[6] The so-called "profits" may be distributed to shareholders or otherwise consumed leaving insufficient provisions for the replacement of worn out assets.[7]

C. The Future Course of Tax Rates

Speculation concerning the future course of tax rates form a partial but important basis for investment decision making. The investor may assume rates to increase, decrease or remain constant. In the case of an expected tax increase or the imposition of a tax where it previously did not exist, investors might be induced to sell their assets in anticipation of confiscatory or substantial tax increases, particularly as there would be no background of practical experience on which to base future expectations. The possibility of appreciation in market

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[6] Careful distinction must be made between a charge for depreciation - which aims at providing for the writing off of an asset - and a provision for replacement of the asset itself. If prices remain fairly steady over the life of an asset, then the charging of depreciation calculated on the original book value of the asset will automatically result in the retention of profits of a like amount and, provided the cash representing these profits is not used for another purpose, funds will be available to buy a new asset at the proper time. But the object of the depreciation charge is still essentially the writing off of the old asset. In times of rapidly rising prices it is clear that the funds set aside by a depreciation provision calculated on the dollars representing original cost will not be sufficient to provide the dollars required to buy a new asset at an inflated price.

[7] C. W. Cloe, "Capital Gains and the Changing Price Level," National Tax Journal, V (September, 1952), pp. 207-17.

value of the assets might offset and outweigh the possibility of loss through increased taxation and the investor may decide to postpone disposal. In general, though, the effect of an anticipated tax increase would act as an incentive to sell. Unless the anticipated tax increase were substantial, it is unlikely that its effect would be overwhelming, particularly in an atmosphere of steadily appreciating market values of assests. Similarly, in the case of an anticipated tax decline, investors would be tempted to hold on to their investments, but if the act of holding on would jeopardize the realizable value of the asset in question, then the tax considerations may be insufficient incentive and the asset may be sold, anticipated tax developments not withstanding.

D. Dividend Policy and Misallocation of Investment Funds

How are corporate decisions concerning corporate dividend policy, corporate investment and the valuation of securities affected by preferential tax treatment of capital gains?

Dividend receipts from Canadian corporations are subject to regular graduated tax rates after deducting a 20% dividend tax credit allowance under section 38(1) of the Income Tax Act. However, the proceeds on sale of securities are considered a return of capital or a capital gain, unless the vendor is in the business of dealing in securities. This provision induces entrepreneurs and managers to divert funds from dividend payments to the retention of earnings in the company, since such retention of earnings appreciates the net worth of the firm and thereby creates a non-taxable capital gain for the firm's shareholders when they decide to sell their securities. Investors will, therefore, prefer to supply funds to corporations with high rates of retention, thus favouring the large, conservative public firms with an established reputation for low dividend payments and high earnings. These firms enjoy the advantage of being temporarily exempt from having to offer immediate evidence to the market that the funds are being profitably employed. This enables these firms to invest into research and development projects which would not meet the desired rate of return until after a gestation period of several years duration. The firm whose policy has been to pay high rates of dividends and which is consequently compelled to go to the market for new capital, must immediately persuade prospective investors of the profitability of their funds. The two types of firms are not subject to the same test of economic profitability. The former can defer scrutiny of its performance to a later date, thus permitting it to invest in activities yielding less than current rates of return at the present. In a technologically based society, such as ours, it is a formidable advantage to be able to invest in costly research projects which, although not immediately productive, may nevertheless yield handsome returns in the future. The latter is immediately exposed to the icy penetrating look of the prospective investor. To the extent that retained earnings are invested in projects that do not ultimately produce satisfaction, while funds committed under market scrutiny offer better returns, it seems likely that a more efficient allocation of investment could be accomplished by taking capital gains on securities at the same rate and on the same basis as other income. This situation may be the cause of unnecessarily high market rates of interest. Investments derived from the sale of new issues must indicate a higher rate of return than investment originating in retained earnings because the retention of earnings reduces the supply of funds available for investment purposes; therefore, the removal of preferential tax treatment of capital gains would immediately increase the supply of funds available in the capital market, by eliminating the existing inducement to retain funds in the firm. The larger aggregate dividend payouts would provide the extra funds required for a more liquid and active market. Thus, the traditional contention that capital gains are necessary for greater liquidity and higher turnover in the capital market, loses much of its common-sense appeal.

E. The Locked-in Effect

The argument that a capital gains tax will probably reduce the dynamic efficiency of the market as a resource-allocation mechanism by obstructing the flow of capital from relatively stagnant and declining firms and industries with low marginal prodictivities to vigorous and rapidly expanding areas with high marginal productivities of capital, deserves scrutiny. This raises the issue of the "locked-in effect." The imposition of a capital gains tax may be instrumental in creating an atmosphere of reluctance to sell assets, irrespective of market indications to the contrary, due to the desired postponement or avoidance of tax payment on such asset realizations. As a result, capital markets may lose much of their resilience and become unresponsive and sluggish to the requirements of supply and demand. The greater rigidity of capital markets impedes economic growth and efficient allocation of capital resources. This argument becomes relevant only under a so-called "pure realization tax", under which asset dispositions by gift or bequest fail to be treated as asset realizations for tax purposes, and where, for capital tax purposes, the beneficiaries are allowed to transfer assets at current prices. Such a system permits escape from a capital gains tax for an indefinite period by passing on the accrued gains from generation to generation, without ever affecting the realization, and therefore, the taxability of the assets involved. The forcefulness of this argument may be exaggerated, however, since indefinite postponements of asset realization bear concomitant risks of decline in value of assets and possible stagnation of entire industries. The 'freeze-in' of assets caused by the abolition of the tax-free status of capital gains would at least be partially offset by the foregone opportunity for further gains which might accrue if the proceeds on disposal of currently held assets were reinvested in a more lucrative venture.

If capital losses were permitted to be used as deductions against earned capital gains realizations, then the imposition of a capital gains tax would tend to encourage the sale of assets and would thus at least partially counteract the "locked-in" effect of a capital gains tax. By treating transfers of property by gift or inheritance as effective realizations of gains for tax purposes, the incentive to delay asset realizations and the undersirable effects of such delays on efficient resource allocation can be avoided.

F. Speculation and Gambling

The present absence of a capital gains tax removes restraints on market activity and encourages conversion of investors into mere speculators and gamblers. Market activity is a means to the efficient allocation of investment funds, but cannot be considered an end in itself. To the extent that market activity leads to specualtion and gambling, the energies and resources of the speculators and members of their entourage could be used more efficiently in useful, productive endeavours, and therefore, the present absence of a capital gains tax hinders rather than improves the allocation of human and material resources.[8]

G. Administrative Feasibility

A second criterion for an efficient tax is that it should be administratively feasible. A tax on capital gains does not meet this test very well. Problems involved in administering a capital gains tax range all the way from technical accounting and auditing difficulties involved in efficient detection of tax avoidance to general problems of tax compliance enforcement.

One problem is that of asset valuation. While this problem could be considerably reduced by taxing only realized gains, there would still be a need to assign initial values to assets in order to ascertain the precise quantum of gain. To assign accurate and correct values to millions of assets would require an enormous staff of appraisers, auditors and engineers, unless the process were to be spread over an

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[8]For a detailed discussion of this argument, see:

H. M. Somers, "An Economic Analysis of the Capital Gains Tax," National Tax Journal, I (Sept. 1948), pp. 226-32.

H. C. Wallich "Taxation of Capital Gains in the Light of Recent Economic Developments," National Tax Journal, XVIII (June, 1965).

A. J. Merrett, "Capital Gains Taxation, the Accrual Alternative," Oxford Economic Papers, XVI, (July, 1964), pp. 262-274.

Goffman, *op. cit.*, pp. 235-244.

unreasonably long period of time.

The problems of detection and compliance raise such issues as how and by what means would the government ensure enforcement of the law on gains realized in betting, gambling and other illegal activities. A vast and continuous flow of presently unreported stock transactions, representing haphazard investments and speculative decisions by huges masses of financially unsophisticated people, would have to be reported, sorted, and allocated to each individual taxpayer. The unavoidable administrative enforcement costs might prove uneconomical. Essentially, much of the burden of keeping accurate, long-term records of transactions would have to be placed on the taxpayer, who by virtue of his limitations might either decide to desist from further trading or attempt to keep the necessary records at enormous real costs to the economy in terms of foregone alternatives of productive work or leisure. These and similar problems involved in taxing capital gains require practical solutions before proceeding with any suggested implementation of a capital gains tax. Much can be learned from the American experience and every effort should be made to study it and benefit by it.

Opponents of the capital gains tax argue that no net revenue accrues to the government in the long-run because losses and gains tend to offset one another over a period of years. Although American experience indicates positive net revenue, it is argued that it results from partial loss allowances and that had losses been fully deductible net revenue would have been zero.

The fact of the matter is different. Net revenue might, in fact, accrue to the government even if gains and losses were to balance one another over time because in periods of prosperity, higher average incomes, compounded by the gains themselves, will place the taxpayers in higher marginal tax brackets. In periods of recession or business slowdowns, average incomes will tend to be lower and tax savings based on losses of identical size to the gains of the preceeding period will be smaller because of the lower marginal tax rates. Thus, a gain may be taxed at 60% while an identical loss may realize only a 40% tax saving because of the lower marginal tax rates.

The problems involved in taxing capital gains are considerable and even when the highly controversial topic of whether capital gains should be taxed at all has been resolved, answers and solutions to practical problems of assessment, enforcement, detection and asset valuation will have to be found. U.S. experience, however, would indicate that the problems of administration are not insurmountable.

CHAPTER IV

THE EQUITY ARGUMENTS FOR FULL TAXATION OF CAPITAL GAINS

The question of a capital gains tax can be viewed from an equity point of view as well as from the point of view of its economic effects and its administrative feasibility. A survey of arguments based on economic effects of a capital gains tax is most inconclusive and highly speculative. Until such time as these conjectures, concerning the economic effects of a capital gains tax become more reliable by means of further empirical research, the principal and most cogent of arguments will rest on equity considerations.

The principal equity arguments against the capital gains tax are that: (1) capital gains do not constitute income and therefore, are unable to bear taxes like other income, (2) capital gains are illusory paper profits caused by inflation and therefore incapable of bearing taxes like ordinary income, (3) active investors who sell and buy assets frequently are discriminated against, in favor of passive investors who do not trade in assets and (4) capital loss allowances are unfair to investors because the tax savings arising from loss deductions never quite offset the additional tax due to the graduated income tax.[1]

Some economists regard income and capital as quite distinct. Dan T. Smith, proposes tax exemptions for capital gains on grounds that they are not income.[2] This argument is based on the view that income is what an individual can spend without impairing the integrity of his capital.[3] As mentioned earlier, the tree-fruit analogy often serves to illustrate the distinction between capital and income.[4] The crop of apples is income while the growth of the tree is capital appreciation. A full-grown tree remains pretty much the same year after year while each new crop of apples represents an annual flow which can be consumed without impairing or in any way jeopardizing future yields of apples. If the apple orchard has been cultivated from its inception as plants, then the matured orchard represents a capital appreciation which is included in capital.[5]

The dialogue on trees and apples is intended to clarify the distinction between income and capital. Capital is viewed as a 'stock' and income as a 'flow'. Dan T. Smith

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[1] Walter S. Blum, "A Handy Summary of the Capital Gains Argument," Taxes, (April, 1957), pp. 247-266.

[2] Income Tax Revision, panel discussion before the committee on Ways and Means, House of Representatives, 86th Congress, 1st Session, Nov. and Dec. 1959 (Washington: Government Printing Office, 1960), pp. 696-697.

[3] Ibid.

[4] Ibid.

[5] Ibid.

maintains that capital gains should not be taxed because they are not income and are inherently embodied in the capital at all times. Furthermore, they are not available for spending without impairment of the economic well-being of the taxpayer.[6] The opposing view expressed by Stanley Surrey and other economists stresses that the overall economic well-being of the taxpayer is enhanced by a capital gain and therefore such gains should be taxed.[7]

If we accept Surrey's view that realized capital assets increase economic well-being and confer taxpaying ability, then in the interest of equity, capital gains originating in the same tax period as other forms of income warrant the same tax treatment as ordinary income.[8] Otherwise, the present tax-exempt status of capital gains results in unequal treatment of equals. Taxpayers with similar incomes and equal facilities for paying taxes are not treated equally for tax purposes.[9] Furthermore, since after-tax gains add to resources used to generate additional gains, the present refusal to tax gains as ordinary income leads to progressively larger and larger disparities in income. It permits a proportionate increase in income without a

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[6] "Income Tax," p. 701

[7] Ibid., p. 697.

[8] Ibid.

[9] John K. Hulse, "The Capital Gains Tax and the Stock Market," Taxes (August, 1956), p. 521.

proportionate increase in taxes. Violation of these equity standards provides ample opportunity for taxpayers to avoid their fair share of the tax burden simply by arranging their affairs in a manner which makes capital gains rather than ordinary income their source of taxpaying ability.[10] Similarly, violations of equity standards occur when taxpaying ability is denied because capital gains are viewed as mere paper profits caused by inflation.

The charge that capital gains are illusory paper profits stresses the alleged inability of capital gains to bear a tax because they stem from the inflationary process and reflect a general price level increase. In the U.S.A. the New York Stock Exchange advocates the reduction or elimination of the capital gains tax on these grounds.[11] The argument rests on the assertion that since such gains do not increase real economic power, the taxpaying ability of the taxpayer has not increased either.[12] Although admittedly, a greater or smaller proportion of capital appreciation might reflect nothing more than a general price level increase, it is also maintained that this is not the only source of increase in the value of capital assets.[13] This

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[10]Harvey L. Lutz, "Taxing Capital Gains," Wall Street Journal, Feb. 7, 1963.

[11]G. Kieth Funston, "Needed: A Fair and Warmer Investment Climate," remarks before the 61st annual Congress of American Industry (New York City, Dec. 6, 1967).

[12]Walter S. Blum, op. cit., p. 248.

[13]Factors Affecting the Stock Market, staff Report to the Senate Committee on Banking and Currency (Wash: Gov't Printing Office, 1955), p. 10.

is suggested by the following example. Stock market values have increased by 50 per cent from 1953 to 1955. This has added $75 billion to stock market values.[14] The consumer price index which measures the general price level shows it to be 93.2 per cent of the 1957-59 base year at the beginning of the period and 93.3 per cent at the end of the same period, the high of the period registering at 93.6 per cent in 1954.[15] These data indicate that much of the rise in asset prices at any given time are due to forces other than rising price levels.

From an equity point of view there are two main considerations in the argument that capital gains are illusory paper profits: (1) the change in general price level and (2) the length of period in which such gains accrue. Assuming that the gains are realized, equal amounts of gains and ordinary income earned in the same period of time should be taxed at equal rates because of equal taxpaying ability. It is important to acknowledge the possibility that a capital gain may have accrued over a period of years, in which case gains attributable to previous periods should be prorated over the years during which the gains accrued. If this were not recognized, some taxpayers would be taxed at a higher rate than their taxpaying ability indicates, due

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[14] Ibid.

[15] Economic Report of the President (Washington: Gov't Printing Office, 1963), Table C-43 and C-70.

to the bunching-up of gains.[16]

During periods of general price level increase, all taxpayers experience a reduction in their command over goods and services, but those who realize capital gains are better off by the amount of these gains than those with fixed incomes.[17] As claimants of capital gains improve their position in relation to earners of ordinary fixed income, a larger proportion of their gains should go to taxes in order to prevent a redistribution of income by inflation. Therefore, the present system of exempting capital gains from taxation leads to violation of the principle of vertical equity.

A further distinction need be made between the cash basis and the accrual basis of taxing capital gains. If only realized gains are to be taxed, active investors would be discriminated against.[18] The after-tax net worth of the active investor would be continually reduced by the amount of the gains tax, where as the net worth of the passive investor would remain unimpaired. This is a case where the equal treatment of equals is violated since there is a capital diminishing tax on realized gains while equal amounts of accrued unrealized gains go untaxed. This

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[16] Blum, op cit., p. 253.

[17] Ibid.

[18] The Federal Revenue System: 1961, materials assembled by the Committee Staff for the joint Economic Committee, Congress of the United States. (Washington: Gov't Printing Office, 1961).

suggests the propriety of taxing unrealized gain. A tax on unrealized gains may seem appropriate from the point of view of equity but on practical administrative grounds, such procedure is somewhat inexpedient. Taxation of unrealized gains would require a periodic re-evaluation of capital assets.[19] Furthermore, the taxation of unrealized gains might cause undue hardship to those taxpayers who would be compelled to sell all or part of their holdings in order to raise the funds with which to pay the tax. Such procedure would discriminate against those compelled to liquidate their assets in order to pay the tax by creating a buyers' market for their assets and forcing them to accept the best immediate offer. Such forced liquidations may even wipe out the very gains on which the tax is levied. Persons with ability to pay are favoured inasmuch as they can withhold their assets from the downward pressure of a possible buyers' market and thereby obtain a better price for their asset at some more opportune time. On the other hand, it is argued that the failure to tax unrealized gains tends to permit those with an ability to pay to escape their fair share of taxes. Fundamentally, however, the equity argument that active investors are discriminated against rests on the assumption that only realized gains are to be taxed. A situation arises wherein taxpayers with similar incomes, from similar sources are treated

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[19] Ibid.

unequally, depending on whether they choose to retain their holdings or dispose of them. The proposal to tax unrealized gains would at least adhere to the requirement of horizontal equity, that taxpayers with equal amounts of gain, whether realized or not, would receive identical tax treatment. The taxing of unrealized gains would forestall a worsening of the situation between investors realizing capital gains, in terms of vertical equity, because both realized and unrealized gains would be subject to tax. From the point of view of equity, the uniform taxation of unrealized gains would appear desirable, in spite of the afore mentioned weaknesses and criticism of this method of taxation.

Harold M. Groves has suggested that capital losses be entitled to parity treatment with capital gains,[20] meaning that capital loss allowances be taxed at the same rate as capital gains. To illustrate, a capital gain taxed at 15 per cent would call for a limit of 15 per cent of the capital loss to be allowed as a deduction from other income. Full capital loss allowance would permit a taxpayer to reduce his income and tax liability to zero if his capital losses exceeded capital gains. For example, in the U.S.A. where the maximum rate of tax on capital gains is 25 per cent, a taxpayer would only partially assume his tax share. Therefore, a proposal to allow a full capital loss

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[20] Harold M. Groves, "Taxation of Capital Gains," <u>Ways and Means Compendium</u>, Vol. 2, p. 1200.

deduction under a system of preferential tax treatment of gains would be inequitable because it would descriminate against taxpayers with ordinary income and would favour those with incomes partially derived from gains. In any case, the handling of capital losses is crucial to the objectives of tax equity as illustrated by the U.S. experience of the 1930's when it was found that taxpayers tended to postpone realizations and cash in on losses at the earliest opportunity.[21] In accordance with the principles of equity, a full capital loss allowance against ordinary income would be permissible only under a regime of taxation which includes all capital gains in ordinary income subject to ordinary rates of tax.

It would therefore seem reasonable to evaluate the present tax treatment of capital gains in the light of the equity criteria developed earlier. The basic equity arguments for the full taxation of capital gains at regualr progressive rates are that: (1) the index of equality should be defined in terms of change in economic power, irrespective of whether such change consists of changes in income or capital; (2) the principle of horizontal equity demands the equal treatment of people in equal positions, irrespective of the source of such accretions of economic power; and (3) the principle of vertical equity demands

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[21]Anita Wells, "Legislative History of Treatment of Capital Gains under the Federal Income Tax, 1913-1948," National Tax Journal, (March, 1949), pp. 12-31.

that people in unequal positions be subject to moderately progressive rates of taxation.[22]

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[22]Blum, <u>op cit</u>.

CHAPTER V

CONCLUSIONS

The foregoing evaluation of the capital gains tax is based on consideration of its economic effects, administrative feasibility and the demands of horizontal and vertical equity.

The economic arguments against the capital gains tax are often based on inadequate analysis, faulty analogies and fragmentary information. For lack of sufficient empirical data, a definite stand has been avoided concerning the probable economic effects of a full income inclusion of capital gains and losses. The result of this procedure is that important aspects concerning the taxation of capital gains are summarily dismissed. It is probable, however, that the main cost of capital gains taxation would be a reduction in the private savings ratio with possibly unfavourable implications for economic growth, although the deleterious growth effects of the fall in private savings could conceivably be offset by increased public savings through increased tax revenue.

The present system of treating capital gain for tax purposes is responsible for much uncertainty. Much of the uncertainty can be traced to the nature of the Income Tax Act, Departmental assessment policies and Judicial decisions.

First of all, capital gains are not separately and explicitly defined in the Income Tax Act. It is essentially a residual concept, embracing everything not falling within the meaning of income. This approach fails to illuminate the issue, since the income definition is both vague and confusing. Since the charging section of the Act is open to speculative interpretation and much ambiguity, the Act itself is an inadequate guide in providing a precise idea for the concept of income or capital gain. Consequently, the taxpayer's interpretation of capital gains may and frequently does differ from either that of the Department or the Courts. This unavoidably leads to much costly litigation and waste of human energies diverted from productive effort to futile and unproductive disputations.

With respect to the question as to whether court judgements provide any more certainty on the nature of capital gains, Stanley E. Edward had this to say at the 1962 Conference of the Canadian Tax Foundation:

> In Canada the statute law on the subject of capital gain is very simple, bordering on the non-existent. However, the judgment law is complex, bordering on the confusing.[4]

The confusion arises from the fact that each case heard by the courts for capital gains[5] as a framework for the recognition of capital gains has proved impractical. The use of these judicially formulated tests of what constitutes capital gains is unreliable to say the least. This is not because the tests are inapplicable, but because few cases, if any, fall into a single category. In case-law all of the unique circumstances present determine the nature of the decision. Therefore, in most cases the courts rely on several of the tests in arriving at an opinion. The only generalization based on court decisions which could be validated is that profit from a transaction possessing only one of the characteristics of income will not be taxed, while it seems impossible to ascertain the precise number of attributes of income which would make a transaction taxable. Nowhere can be found any objective test specifying the number of income attributes necessary to render a profit taxable, nor is it likely that a universally acceptable set of circumstances will or ever can be devised

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[4] Ibid., p. 87

[5] Taylor U. M. N. R., 56 DTC 1125.

to serve as a reliable basis for income-gains classification. The vague, ambiguous and obscure nature of judicial jargon further obscures the meaning of otherwise simple concepts. For example, the frequency of occurrence of gains is one of the more important indicators of whether or not a gain is to be construed as income for tax purposes. The concept of recurrence, while simple in its everyday usage, is most obscure and perplexing in its judicial meaning. While early Canadian law stressed the likelihood of recurrence as crucial, later decisions view it either as an *ex post* or an *ex ante* concept. The appearance of the doctrine of secondary intention provides strong evidence of the widening scope given to the meaning of income by Canadian Courts. According to Shinder,[6] capital gains are a vanishing phenomenon in Canada and the courts merely reflect this fact in their decisions. This trend would suggest that the recommendations for the full inclusion of gains in income would represent less of an innovation than a clarification of an obscure, ill-defined and enigmatic area of tax law.

The evaluation of capital gains tax from the point of view of equity indicates that arguments against the capital gains tax on equity grounds are unsupportable. The arguments against the full inclusion of capital gains in income

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[6] B. B. Shinder, "The Taxability of Capital Gains in Canada," Faculty of Law Review, University of Toronto, XIX (April, 1961), p. 87.

for tax purposes obscures the obvious fact that the tax exempt status of capital gains imposes inequitable relationships among taxpayers according to the source of their income and taxpaying ability. In the interest of equity between investors with gains, the above discussion suggests that the unrealized portion of capital gains should be taxed, notwithstanding the problems arising from the need for appraisal of all assets annually. The full inclusion of gains and losses in ordinary income would eliminate inequities between taxpayers arising from the present tax-exempt status of capital gains. It would therefore appear that on the basis of equity, the preferential treatment of capital gains is neither necessary nor desirable and the full inclusion of capital gains in ordinary income would increase opportunities for equalizing the tax treatment of gains and ordinary income.

Suggested Changes

The tax treatment of capital gains depends in the final analysis on the definition of income we choose to adopt and since there is very little agreement among economists on this matter, the choice will depend on the appreciation and understanding of its equity and economic-effect implications. There are powerful arguments based on considerations of both horizontal and vertical equity for the full inclusion of gains into income. Practical considerations would suggest that the tax be levied only on realized gains with full allowance for and a generous carry-forward provision of realized losses. Transfers by bequest or gift should be treated as constructive realizations and although some inequities would be unavoidably introduced by these measures, the distributional benefits would by far outweigh the disadvantages involved. To eliminate inequities stemming from the taxation of gains in a single year which represent several years of appreciation, a special provision permitting a formal spreading of such gains over several years, may be worth considering. This may be particularly applicable to dealing with gains from the sale of owner-occupied dwellings. The recognition that gains often represent several years' appreciation does not justify the abandonment of full inclusion of gains in income.

The recommendation of the Royal Commission on Taxation[7] regarding the tax treatment of capital gains supports the conclusion of this thesis,[8] that capital gains be fully taxed at regular graduated rates applicable to ordinary income and that capital losses be fully deductible. The Report extends recognition to the possible adverse economic

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[7]Royal Commission on Taxation, Report, P. C. 1962-1334, September,25, 1962, hereinafter referred to as "Commission."

[8]The arguments, conclusions and recommendations of this thesis were developed independently of the Commission Report and prior to its publication on February 24, 1967. However, I am relieved to find that its recommendations concur with my own conclusions.

effects of such a tax on capital accumulation and seeks to reduce or forestall such undesirable consequences by recommending greatly reduced marginal rates of tax with the maximum rate limited to 50 per cent.[9]

In its recommendations concerning capital gains, the Commission has consistently given the greatest weight to the objectives of horizontal and vertical equity, recognizing the fact that taxation is essentially a method of transferring command over goods and services from individuals and families to the state and that if equity were not a vital concern, taxes would be unnecessary since the state could simply procure what it needed by appropriating the means of those citizens who happen within easy reach of the state.

The spirit and content of the Commission's recommendations on capital gains taxation is perhaps best conveyed in the following paragraph:

> We are completely persuaded that taxes should be allocated according to the changes in the economic power of individuals and families. If a man obtains increased command over goods and services for his personal satisfaction we do not believe it matters, from the point of view of taxation, whether he earned it through working, gained it through operating a business, received it because he owned property, made it by selling property or was given it by a relative. Nor do we believe it matters whether the increased command over goods and services was in cash or in kind. Nor do we believe it matters whether the increased economic power was expected or unexpected,

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[9] "Commission," <u>op cit</u>., Volume 2, paragraphs 175 and 247.

> whether the man suffered to get the increase in economic power or if it fell in his lap without effort.
>
> All of these considerations should be ignored either because they are impossible to determine objectively in practice or because they are irrelevant in principle or both. By adopting a base that measures changes in the power, whether exercised or not, to consume goods and services, we obtain certainty, consistency and equity.[10]

The Commission's recommendaations concur with the conclusion, that the present system of exempting gains completely from taxation or taxing them at reduced but progressive rates or on a percentage inclusion basis involves the hypocrisy of dipping deeply into large incomes and sifting them with gaping sieves.[11] The present tax treatment of capital gains ignores the fact that the first and most important goal of taxation is to share the burden of state fairly and equitably among all taxpayers.

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[10] *Ibid*., Volume 1, p. 8.

[11] In arriving at these conclusions numerous court cases were examined as indicated in Appendix I.

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APPENDIX I

Table of Cases

No. 215 v. Minister of National Revenue, 54 DTC 549.
No. 341 v. Minister of National Revenue, 56 DTC 231.
No. 351 v. Minister of National Revenue, 56 DTC 375.
No. 371 v. Minister of National Revenue, 56 DTC 553.
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