Planning for a potential hike in the capital gains inclusion rate

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Jamie Golombek

Managing Director, Tax and Estate Planning, CIBC Private Wealth Management

While the November 30 federal fiscal update didn't contain any specific tax measures (as those are usually reserved for a spring budget), investors have been wondering, yet again, whether capital gains taxes could be on the government's agenda, given the massive COVID-19 relief spending and some recent international developments. Let's look at some trends in taxation of capital gains, both in Canada and globally, as well as some planning for any potential increase in the capital gains inclusion rate.

Trends in capital gains taxation

The capital gains tax, of course, is only a concern if you hold appreciated investments in a non-registered account. Under Canadian tax law, only 50 per cent of capital gains are taxable, at your marginal rate. Depending on your province of residence, for high-income earners, the marginal tax rate on capital gains in 2020 can be as high as 27 per cent.

And, as it turns out, high-income earners pay the majority of capital gains tax. The latest income tax statistics (from 2017) show that only about 10 per cent of the 28.5 million personal tax returns filed that year reported any taxable capital gains. And of the $37 billion in aggregate taxable capital gains reported, over three-quarters of the gains (almost $30 billion) were earned by the 10 per cent of taxpayers with income over $100,000 (roughly 760,000 filers), while 55 per cent ($20 billion) of the total gains were realized by the one per cent of taxpayers with income over $250,000 (about 160,000 filers).

According to the 2020 Report on Federal Tax Expenditures[1], the partial inclusion of capital gains for individuals and corporations will result in a "tax cost" to the government in 2021 estimated at $22 billion. The report says that, "This measure provides incentives to Canadians to save and invest, and ensures that Canada's treatment of capital gains is broadly comparable to that of other countries."

But other countries' rates may soon be in flux. In November 2020, the U.K.'s Office for Tax Simplification released a new report[2] on overhauling the U.K.'s capital gains tax system, suggesting that aligning the U.K. capital gains tax rates with general income tax rates could generate significant revenues for the government, which could effectively double the tax cost of selling an investment with inherent gains. Indeed, as reported in the Financial Times[3], some U.K. senior executives are preparing to sell down their stakes in their corporations for fear of a potential capital gains tax increase.

South of the border, changes may also be coming to the taxation of capital gains based on president-elect Joe Biden's platform. Currently, the U.S. taxes short-term gains (for sales of assets held less than one year) at

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1 The 2020 "Report on Federal Tax Expenditures" is available online at canada.ca/en/department-finance/services/publications/federal-tax-expenditures/2020.html.

2 The report "Capital Gains Tax review – first report: Simplifying by design" is available online at assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/935073/Capital_Gains_Tax_stage_1_report_-_Nov_2020_-_web_copy.pdf.

3 The article "UK bosses rush to sell stakes over capital gains tax fears" is available online at ft.com/content/0129ca54-bb8e-4b06-8afd-0ff7ccb2233d.

ordinary income tax rates, which range from 10 per cent to 37 per cent federally. Long-term capital gains (for sales of assets held longer than one year) are taxed at a favourable rate, ranging from zero to 20 per cent (excluding the additional 3.8 per cent net investment income tax — or "NIIT" — for higher-income earners.)

The Biden proposal would effectively increase the tax on capital gains by treating them as ordinary income for taxpayers earning more than US$1 million. Combined with his plan to raise the top rate on ordinary income back up to 39.6 per cent (from 37 per cent), it would nearly double the current long-term capital gains tax rate to 43.4 per cent (39.6 per cent plus the 3.8 per cent NIIT) from 23.8 per cent (20 per cent plus 3.8 per cent) for these high-income individuals. Biden, however, may not be able to get this tax increase through unless the Democrats can pull off a double victory and capture control of the U.S. Senate by winning the January runoff elections in Georgia.

So, what about Canada? You'll recall that prior to Jan. 1, 1972, Canada didn't tax capital gains at all. Then came the Carter Commission Report, which recommended full taxation of capital gains. But the law, as originally introduced, only taxed 50 per cent of capital gains. Subsequent governments increased the inclusion rate to 66.67 per cent in 1988, then increased it again to 75 per cent in 1990. A decade later, it was dropped back down again to 66.67 per cent on Feb. 28, 2000, and then further reduced on Oct. 18, 2000 to 50 per cent, where it has remained until today.

In the government's pre-budget consultations leading up to this year's non-budget, the Standing Committee on Finance heard from nearly 70 organizations and individuals in Ottawa from Feb. 3 to 6, 2020, and received more than 270 briefs. In its final report issued earlier this year, the proposed recommendations on taxation included no increases to the personal income tax rates or the capital gains inclusion rates.

But, judging by the tone of some of the nearly 800 submissions the government received in Pre-budget consultations in advance of the 2021 budget[4], the mood may be changing in light of the unprecedented government spending on COVID-19-related relief for Canadians and business, with a 2020-21 deficit potentially hitting as high as $400 billion. The written briefs, together with testimony from pre-budget hearings which began this past Monday, will be used to produce the Committee's pre-budget consultations report, expected next month.

For example, the Broadbent Institute, in its submission titled Paying for the Recovery We Want[5] called on the government to "End tax breaks for the rich and crack down on tax avoidance. Only one-half of capital gains and stock options are liable to tax, while wages are 100 per cent subject to tax. The dividend tax credit also lowers effective taxes for the very few Canadians who earn significant investment income outside pension plans and RRSPs. These tax breaks should end."

The "Canadians for Tax Fairness" submission[6] also recommended that the federal government's top priorities should include "reduction of the dividend tax credit and increasing the inclusion rate for capital gains."

But, many have argued that capital gains tax hurts innovation by reducing the appetite of investors for riskier startups. A 2017 economic note published by the Montreal Economic Institute[7] calling for the abolition of capital gains tax said it "could encourage productivity growth in Canada, which would in turn improve the living standards of all Canadians."

Another problem that some see with capital gains tax is that it encourages investors in taxable accounts to "lock-in" their investments. After all, there's a tax disincentive to sell an asset that has appreciated significantly in value, even if it may make sense to do so from an investment perspective, such as if an alternate asset's future prospects look better than the current holding.

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4 See "Pre-budget consultations in advance of the 2021 budget," which is available online at ourcommons.ca/Committees/en/FINA/StudyActivity?studyActivityId=11021772

5 "Paying for the Recovery We Want" is available online at ourcommons.ca/Content/Committee/432/FINA/Brief/BR10974316/br-external/BroadbentInstitute-10291507-e.pdf

6 The "Canadians for Tax Fairness" submission is available online at ourcommons.ca/Content/Committee/432/FINA/Brief/BR10974044/br-external/CanadiansForTaxFairness-e.pdf

7 "The Capital Gains Tax: It Should Be Reduced, Not Increased" is available online at iedm.org/75509-capital-gains-tax-it-should-be-reduced-not-increased/

Finally, some readers may recall a 2006 Conservative election campaign promise to “eliminate the capital gains tax for individuals on the sale of assets when the proceeds are reinvested within six months.” While this measure was never enacted, the TFSA was introduced a few years later, permitting a portfolio held within a TFSA to be rebalanced tax-free.

Planning for a potential increase in the capital gains inclusion rate

If you’re among those investors who fear that the government may, indeed, increase the inclusion rate, what can you do about it now? The easy thing to do is simply sell your appreciated assets and lock-in your capital gains tax bill at the current 50 per cent inclusion rate. But the problem with that is that if it didn’t make sense to sell an asset prior to a potential tax-rate increase, the fear of such an increase shouldn’t change your investment decision. As we often say, “don’t let the tax tail wag the investment dog.”

But there may be ways to have your cake and eat it too, albeit with some additional tax planning complexity and compliance costs. It may be possible, depending on your circumstances, to crystallize any latent capital gains on your assets in order to benefit from the current inclusion rate. In addition, it may be possible to implement a crystallization strategy without having to pay tax in respect of the resulting capital gains if an increase to the inclusion rate is not enacted. These crystallization reorganizations would have to be completed before the capital gains inclusion rate is actually increased.

The basic strategy for appreciated securities is to sell the securities to a Canadian holding company (either new or existing) in exchange for shares with a fair market value (FMV) equal to the FMV of the securities being transferred. This is a taxable transaction and triggers the capital gain.

If the capital gains inclusion rate increases in a spring 2021 budget, you do nothing more and have crystallized the gain at the current, 50 per cent inclusion rate. The cost of the securities to the holding company will be the securities’ FMV.

If, on the other hand, the capital gains inclusion rate does not increase, you can file a “section 85” rollover election and elect that the securities be sold for tax purposes at their adjusted cost base (“ACB” or tax cost) so that no gain is realized. The cost of the securities to the holding company will be the elected amount (that is, your ACB).

But, since the strategy involves paying the tax today (albeit at the lower inclusion rate), it may not make sense if you are not contemplating a sale of the securities in the near future. That’s because taxes would be paid earlier than they otherwise would be and thus the time value of money would need to be considered in determining whether this strategy makes sense. In addition, you would now own your investment portfolio through a corporation, which adds a layer of complexity that you may not want. Annual corporate tax returns will need to be filed for the corporation and, if you want to take investment income out of the holding company, the corporation will have to declare dividends, which involve director’s resolutions and filing of T5 information tax slips.

Be sure to speak to your tax and legal advisors before executing this strategy.

jamie.golombek@cibc.com

Jamie Golombek, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Private Wealth Management in Toronto.