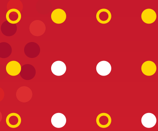
COMMUNIQUE
Volume 17:15
September 2024

Further Thoughts on the Capital Gains Tax

Melville McMillan



http://dx.doi.org/10.55016/ojs/sppp.v17i1.79646

TABLE OF CONTENTS

ABSTRACT 1

REFERENCES 6

ABOUT THE AUTHOR 7

ABOUT THE SCHOOL OF PUBLIC POLICY 8

Further Thoughts on the Capital Gains Tax

Melville McMillan

ABSTRACT

The paper illustrates why Canada's Budget 2024 tax rules do not treat the earners of capital gains uniformly or fairly, because of inflation. The effective tax rates on real capital gains vary substantially among taxpayers depending upon the holding period and the rate of return. Furthermore, capital gain taxes may even create real losses. Uniform inclusion rates applied to nominal capital gains poorly measure real capital gains and typically result in considerable underassessment or overassessment of actual capital gains income (i.e., improvement in purchasing power). An appropriate measure of capital gains should use a cost base adjusted for inflation.

Canada's plan to increase the inclusion rate on capital gains exceeding $250,000 from 50 per cent to 66.7 per cent as announced in the 2024 federal budget has renewed attention on the taxation of capital gains. Some economists (e.g., Tombe 2024) have spoken favourably of this move, because the two-thirds inclusion approximately equalizes the income tax rates applied to corporate value-added, whether distributed as interest, dividends or capital gains. The enhanced neutrality yields efficiency and equity improvements.

On the other hand, the financial media has been replete with concerns and criticisms. Much of that relates to capital gains from real property (notably cottages or second homes[1]), which typically are held for many years before capital gains are realized. Those concerns stem largely from a fundamental, though rarely mentioned, problem of capital gains taxation in Canada—that taxable capital gains are based upon nominal gains. Nominal gains, the simple difference between the sale and original purchase prices (net of sale and acquisition costs), typically do not represent actual income. With inflation, today's dollar does not have the same purchasing power as a dollar many years ago. Hence, capital gain as taxed can be quite different from the real gain in purchasing power (i.e., the appropriate measure of income [2]) that the taxpayer realized. As a result, the effective tax rate on capital gains across taxpayers can be, and generally will be, quite different and therefore unfair. The problem is demonstrated in the following three illustrations.

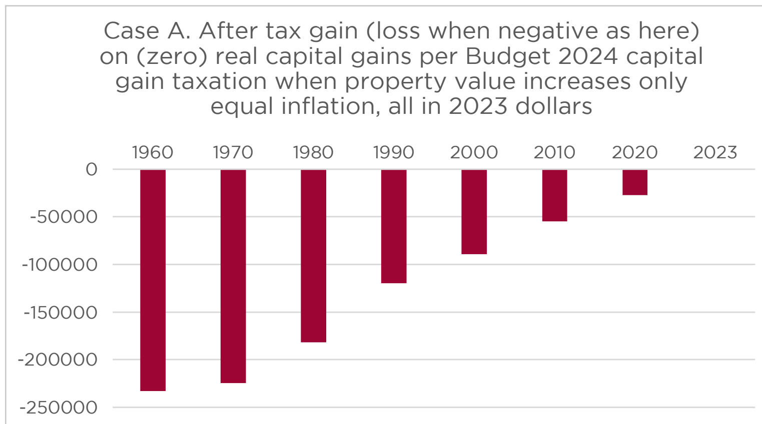
These illustrations consider properties acquired in 1960, 1970, 1980 and so on to 2020, and in 2023. It is assumed that the properties are sold in 2023, but (lacking an inflation rate for 2024) the taxable capital gains are calculated according to the 50 per cent and 66.7 per cent rules introduced in the 2024 budget—that is, as if the 2024 budget rules applied in 2023. The 2023 (net) sale price of the properties is assumed to be $800,000. In the first illustration, Case A, it is assumed that property values increased over time only at the rate of inflation (as measured by the Canadian CPI). In the second illustration, Case B, it is assumed that property values increased at the rate of inflation plus one per cent. Case C demonstrates the effects of higher rates of value appreciation; three and five percent beyond the rate of inflation. The capital gain tax results are presented in the accompanying figures.

In Case A, it is assumed that the post-acquisition value of the property just kept up with inflation. That is, the property served as an inflation hedge and no more. Thus, for example, a property acquired in 1980 for $224,061 (1980 dollars) appreciated to the $800,000 2023 sale price. In that instance, the capital gain measured by the tax authorities would be $575,939 and the taxable capital gain $342,401. Assuming a rate of 53 per cent applied, the tax would be $181,473. Since the increase in the property value only offset inflation, the sale price of $800,000 represents no increase in purchasing power over the years, so the capital gain taxes impose a real (2023 dollar) loss of $181,473 to the property owner. That is, the net of tax proceeds from the sale ($618,527) provides less purchasing power in 2023 than the $224,061 investment in 1980. Such tax-generated losses result for purchases in all years prior to 2023. (The purchase and sale in 2023 is assumed to have a zero capital gain.) Those losses are shown in the Case A figure below. The total after tax losses for properties acquired from 1960 to 2020 range from $232,778 to $27,124. Thus, despite there being no real gain in purchasing power (i.e., no income) because property values only appreciated with inflation, taxable capital gains were assessed, and the taxes paid on those gains imposed real dollar losses on the property owners.

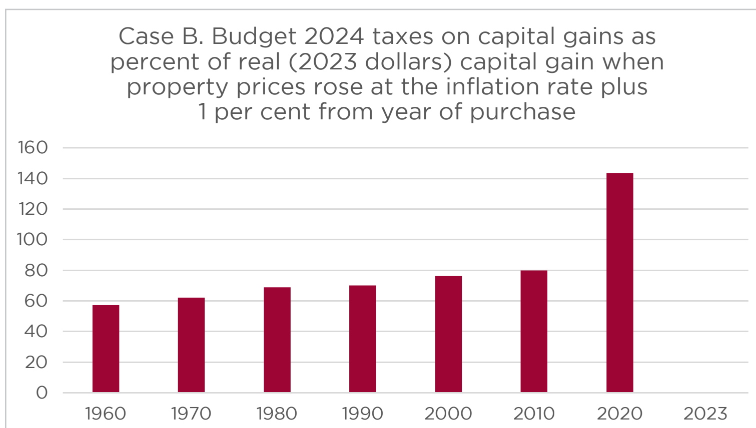
---

1 The problem also relates to business property and farms, and even financial assets if held for extended periods.

2 The standard economic definition of income is the Haig-Simons definition—the money value of the net increase to an individual's power to consume during a period. That is, the real or inflation-adjusted gain. For a discussion of income concepts and complications due to inflation, see H.S. Rosen et al. (2023) especially pages 326–333, 349–351 and 392–393.

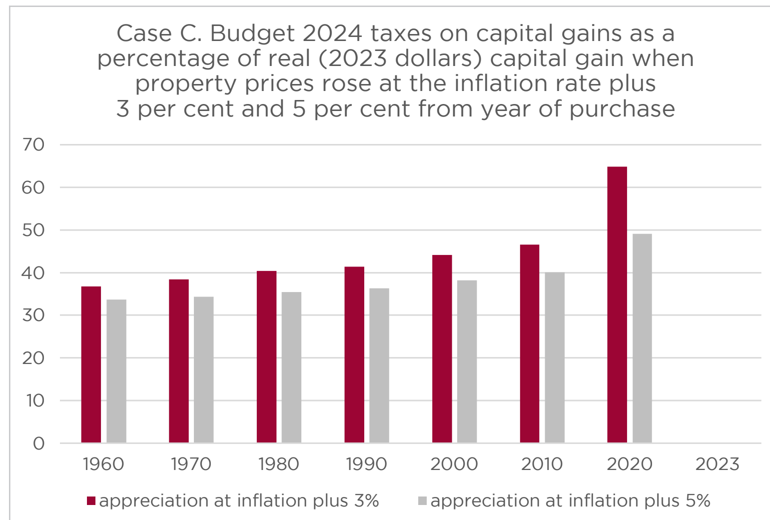


It is reasonable to assume that property prices increase somewhat faster than inflation. Hence, in Case B, it is assumed that a property that sold for $800,000 in 2023 increased in price at the rate of inflation plus one per cent annually. Hence, real capital gains result. In this case, a property acquired in 1980 is obtained for $137,760 and upon sale is deemed to have a (nominal) capital gain of $662,240, a taxable capital gain of $399,964 (under Budget 2024 taxes) and, at a 53 per cent tax rate, tax payable of $211,981. A real (2023) dollar capital gain—that is, an improvement in 2023 purchasing power—of $308,133 is realized in this instance. The taxes payable amount to an effective tax rate of 68.8 per cent on the real capital gain. Parallel calculations for properties acquired in other years are reported in the Case B figure below. Across the years 1960 to 2010, the taxes payable on the capital gains as a percentage of the real dollar capital gains range from 57.2 to 79.8 per cent respectively. Capital gain taxes in the case of the 2020 property convert the real gain of $22,500 into a loss of $9,823, which results in a tax rate of 143.7 per cent on the real capital gain. Even under just the 50 per cent inclusion rate, the capital gain taxes convert the real capital gain into a real loss. In this case, all the effective tax rates on real capital gains exceed the 53 per cent rate applied to ordinary taxable income. That is one problem. A second problem is that the tax rates vary across taxpayers and so further violate horizontal equity.



Variations in the appreciation rates of properties add a further disparity. As the appreciation rate increases beyond the inflation rate, the effective tax rates decline. This is illustrated in Case C for appreciation rates of three and five per cent beyond the annual inflation rate. As comparison with Case B shows, the effective tax rates are lower than when the appreciation rate was assumed to be one per cent. In addition, the effective rates at five per cent are lower than when the appreciation rate is three per cent. To be more specific, if property values increase at the inflation rate plus three per cent, the effective tax rate on the 1960 property is 36.7 per cent, it increases to 50.5 per cent by 2017 and peaks at 71.7 per cent for 2021. However, if the appreciation rate

was inflation plus five per cent, the effective rate becomes 33.7 per cent on the 1960 property, becomes 49.1 per cent for the 2020 property and peaks at 53.4 per cent in the 2021 case. Hence, the percentage of real capital gain income taken as tax varies (not only by the period held but) by the rate of return realized—decreasing as the rate of return increases—when one would expect that fairness requires that personal taxes (when taxed at a constant rate as assumed here) be a uniform percentage of real capital gain income regardless of the rate of return.



These illustrations demonstrate that the Budget 2024 (and the previous) tax rules do not treat the earners of capital gains uniformly or fairly.[3] The effective tax rates vary among taxpayers depending upon the holding period and the real rate of return realized, and, capital gain taxes may even create real losses.[4] This poor treatment results from the inclusion rate being a uniform percentage of nominal capital gains despite inflation having eroded the purchasing power of a dollar. Uniform inclusion rates applied to nominal capital gains poorly measure real capital gains and typically result in considerable underassessment or overassessment of actual capital gains income.[5] An appropriate measure of capital gains should use a cost base adjusted for inflation.

Under the current system, capital gains are taxed differently across comparable taxpayers so taxpayers are treated unevenly and unfairly. If real capital gains were the tax base, capital gains would be taxed at a uniform rate across like taxpayers. Taxpayers without real gains, even if experiencing nominal gains, would (unlike now) pay no capital gain taxes. Assuming that a 53 per cent income tax rate applied to the full amount of real gains, those facing an effective tax rate on capital gains that exceeded 53 per cent of real gains under present methods (e.g., Case B) would benefit from lower taxes on their real capital gains. In situations where a larger real appreciation rate would result in an effective tax rate on real capital gains that was less than 53 per cent (e.g., Case C where effective rates are less than 53 per cent in most instances), those taxpayers would pay greater capital gains taxes than now. Furthermore, these benefiting from a higher rate of return would experience a larger increase in their tax rate. Thus, some earners of capital gains would benefit from a conversion to capital gain taxes assessed on real gains versus the existing system based on portions of nominal gains, while others would lose, but the tax treatment would be equitable and less distorting.

---

[3] The problems exist quite independent of the proposed Budget 2024 changes. The 66.7 per cent inclusion rate on capital gains exceeding $250,000 has only modest impacts on the calculations reported here.
[4] In addition, tax rates vary among individual investments and, again, even real losses may be taxed.
[5] A similar problem arises in the case of capital gains that emerge from holding stocks. See McMillan (2023).

Equity and efficiency call for the taxation of real capital gains. Nevertheless, comparatively few countries do adjust for inflation. Where capital gains arise from real property, as discussed here, six countries index for inflation—Chile, Israel, Mexico, Portugal, Greece and Turkey.[6] Various arguments have been made concerning indexing capital gains,[7] citing the issue of deferred taxes when capital gains are taxed at realization, the treatment of debt, administrative complexities and ensuring that other sources of capital income (notably interest and dividends) are treated appropriately. Nonetheless, Israel, Mexico and Turkey index capital gains from shares as well as real property, and capital gains were indexed in Australia from 1985 to 1999 and in the United Kingdom from 1988 to 1999. Also, Harding and Martens (2018, 14) report that "… a few countries index interest income for inflation." Although existing indexing systems may have their faults, even critics acknowledge the advantages of a comprehensive indexing system implemented through fundamental tax reform.[8] A notable proposal in that direction was made by Helliwell (1969, 1971 and 1972) who advanced a methodology to index the range of incomes from capital assets that dealt, in particular, with the deferral of tax issue.[9] Helliwell also advocated for income averaging, a feature whose adoption for capital gains would be fairer for the large share of capital gain taxpayers, who rarely or infrequently report substantial capital gains.[10,11]

Indexing capital gains for inflation is manageable. As illustrated here, even a relatively simple indexing mechanism for capital gains from property (but ideally also extended to financial assets, notably stocks) could go some way towards improving the equity and efficiency of the Canadian tax system. It is recommended that inflation indexing receive serious consideration and further investigation.[12]

---

6 Also, a presumptive return is used in Netherlands. See Harding and Marten (2018) and Hourani et al. (2023) for a survey of the diverse approaches to taxing capital income in the OECD countries.

7 For example, see Burman (1999), Lochan (2002), Kesselman (2023) and the closing observations in McMillan (2023).

8 For example, note Burman (1999) and Lochan (2002). Slemrod and Chen (2023) note the desirability of indexing and the primarily political difficulty of implementing it and other reforms in the context of the United States.

9 Also see Auerbach (1991).

10 Kesselman (2023) also supports averaging.

11 See Mintz (2024, Table 2) for some evidence of the infrequency with which taxpayers report large capital gains.

12 One may argue that what the tax rate on capital gains (or capital income more generally) should be an open question. Here it is assumed that real capital gains are fully taxable as personal income and taxed at the taxpayer's marginal tax rate (here taken as 53 per cent). In some countries, capital gains are subject to a separate tax schedule typically using lower flat rates. Harding and Marten (2018, 29) note eight such countries including the United Kingdom. What tax rates on capital income are appropriate is a separate question and one that cannot be addressed appropriately without the proper measurement of the capital gains tax base.

REFERENCES

Auerbach, Alan J. 1991. "Retrospective Capital Gains Taxation." *American Economic Review* 81(1), 167–78. https://doi.org/10.3386/w2792.

Burman, Leonard E. 1999. *The Labyrinth of Capital Gains Tax Policy*. Washington, D.C.: Brookings Institution Press.

Harding, Michelle, and Melanie Marten. 2018. "Statutory Tax Rates on Dividends, Interest and Capital Gains: The Debt-Equity Bias at the Personal Level." OECD Taxation Working Papers No. 34. February. https://www.oecd-ilibrary.org/docserver/1aa2825f-en.

Helliwell, John. 1969. "The Taxation of Capital Gains." *Canadian Journal of Economics* 2(2), 314–18. https://www.jstor.org/stable/i300919.

---. 1970. "The Taxation of Capital Gains: Reply." *Canadian Journal of Economics* 3(1), 154–58. https://ideas.repec.org/a/cje/issued/v3y1970i1p154-58.html.

---. 1972. "Towards an Inflation-Proof Income Tax." *Report of the Proceedings of the 24th Tax Conference*, Canadian Tax Foundation, November. 165–74.

Hourani, Diana et al. 2023. "The Taxation of Labour vs. Capital Income: A Focus on High Earners." OECD Taxation Working Papers No. 65. https://doi.org/10.1787/04f8d936-en.

Kesselman, Jonathan Rhys. 2023. "Pathways to Reform of Capital Gains Taxation in Canada." FON Commentaries 3(5), Finances of the Nation. March. https://financesofthenation.ca/wp-content/uploads/Capital-Gains-Tax-Canada-Version-FON-6.2.pdf.

Lochan, Frank. 2002. "Should Inflation Be a Factor in Computing Taxable Capital Gains in Canada." *Canadian Tax Journal* 50(5), 1833–67. https://www.ctf.ca/common/Uploaded%20files/Documents/PDF/2002ctj/2002ctj5_lochan.pdf.

McMillan, Melville. 2023. "Policy Forum: Inflation Indexing and Capital Gains Tax Reform." *Canadian Tax Journal* 71(2), 415–428. https://ctf.ca/common/Uploaded%20files/Documents/CTJ%202023/Issue%202/Public/415_Public-2023CTJ2-PF-4-McMillan.pdf.

Mintz, Jack. (2024). "Deep Dive: The Capital Gains Tax Hike Will Hurt the Middle Class Too." The Hub. Deep Dive 10. June. https://thehub.ca/2024/06/10/deepdive-the-capital-gains-tax-hike-will-hurt-the-middle-class-too/.

Rosen, R.S. et al. 2023. *Public Finance in Canada*. Toronto: McGraw Hill.

Slemrod, Joel, and Xinyu Chen. 2023. "Are Capital Gains the Achilles' Heel of Taxing the Rich?" *Oxford Review of Economic Policy* 39(3), 592–603. https://doi.org/10.1093/oxrep/grad027.

Tombe, Trevor. 2024. "Commentary: Why Raising Capital Gains Taxes Makes Sense—Yes Really." *The Hub*. April 17. https://thehub.ca/2024/04/17/trevor-tombe-why-raising-capital-gains-taxes-makes-sense/.

About the Author

Melville McMillan is Professor Emeritus in the Department of Economics and a Fellow of the Institute of Public Economics at the University of Alberta. His BA and MSc are from the University of Alberta and his PhD is from Cornell University. McMillan's research and teaching interests are in public economics and, in particular, public finance, urban and local economics, fiscal federalism, and the demand for and supply of public goods and services. He has published extensively in these areas and has also advised governments and organizations nationally and internationally (e.g., the World Bank). McMillan served as Chair of the Department of Economics from 1987 to 1997. Although he "retired" in 2010, Melville McMillan has remained active in academic and policy matters but, since June 2022, he no longer maintains an office in the Department of Economics.

About The School of Public Policy

The School of Public Policy has distinguished itself as the leading institution of its kind in Canada, offering a practical, global, and focused approach to the analysis and implementation of public policy across various domains:

1. **Social Policy and Health**
2. **Energy and Environmental Policy**
3. **Fiscal and Economic Policy**
4. **International Policy and Trade**

Our commitment to delivering this unique perspective sets us apart within Canada. The core mission of The School of Public Policy is to bolster Canada's public service, institutions, and economic performance for the betterment of our families, communities, and the nation as a whole. We achieve this by pursuing three key objectives:

- **Building Government Capacity**: We empower public servants through formal training in both degree and non-degree programs. This training equips these individuals, responsible for shaping public policy in Canada, with the practical skills and expertise needed to represent our nation's vital interests, both domestically and internationally.
- **Enhancing Public Policy Discourse**: Beyond government, we foster executive and strategic assessment programs that promote a deeper understanding of effective public policy among those outside the public sector. This effort enables everyday Canadians to make informed decisions regarding the political landscape that will shape their future.
- **Providing a Global Perspective on Public Policy Research**: Through international collaborations, educational initiatives, and community outreach programs, we incorporate global best practices into Canadian public policy. This approach ensures that our decisions benefit the entire populace in the long term, rather than catering to the interests of a select few in the short term.

The School of Public Policy relies on a diverse pool of experts, encompassing industry professionals, practitioners, and academics, to conduct research within their specialized domains. This approach ensures that our research remains highly relevant and directly applicable to real-world challenges. Authors often have personal or professional stakes in their research areas, which is why all Research Papers undergo a rigorous double anonymous peer review process. Following this review, our Scientific Directors conduct a final assessment to uphold the accuracy and validity of the analysis and data presented. This thorough process underscores our commitment to providing credible and actionable insights to inform public policy in Canada.

The School of Public Policy
University of Calgary, Downtown Campus
906 8th Avenue S.W., 5th Floor
Calgary, Alberta T2P 1H9
Phone: 403 210 3802

DISTRIBUTION

For a full list of publications from The School of Public Policy, please visit www.policyschool.ca/publications

DISCLAIMER

The opinions expressed in these publications are the authors' alone and therefore do not necessarily reflect the opinions of the supporters, staff, or boards of The School of Public Policy.

EDITORIAL PRACTICES STATEMENT

This manuscript is a rapid contribution to the policy conversation that has been open-reviewed by at least one University of Calgary faculty member prior to publication.

COPYRIGHT

Copyright © McMillan, 2024. This is an open-access paper distributed under the terms of the Creative Commons license CC BY-NC 4.0, which allows non-commercial sharing and redistribution so long as the original author and publisher are credited.

ISSN

ISSN 2560-8312
The School of Public Policy Publications (Print)
ISSN 2560-8320
The School of Public Policy Publications (Online)

DATE OF ISSUE

MEDIA INQUIRIES AND INFORMATION

For media inquiries, please contact Gord Der Stepanian.

Our web site, **www.policyschool.ca**, contains more information about The School's events, publications, and staff.