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Capital gains taxation in Canada, 1972-2017: evolution in a federal setting

François Vaillancourt* and Anna Kerkhoff**

Abstract

Capital gains taxation in Canada was introduced in 1972 following the recommendations of the Carter Commission. This article will trace the evolution of the system focusing in particular on the following three items:

(1) the interaction between capital gains taxation and provincial succession duties as the latter were driven down to zero in the 1970s (Québec in the 1980s);
(2) the phased introduction (1985-1988) and abolition (1994) of a generally available life-time capital gains exemption; and
(3) the changes in the inclusion rate of capital gains in taxable income (50% in the years 1972-1988; 66.67% in 1988-1990; 75% in 1990-2000; and 75% to 66.66% to 50% in 2000 and 50% thereafter).

The article will start by setting out a brief history of capital gains taxation in Canada. Following this factual part, an examination of the three items mentioned above will be carried out followed by a brief discussion of the post-2000 period.

Key words: capital gains, death taxes, lifetime exemption, inclusion rate

* Emeritus professor, economics, Université de Montréal and a fellow at the Center for Interuniversity Research and Analysis of Organizations (CIRANO).
** Analyst, University of Sherbrooke and, at the time of working on this article, M.Sc. student, economics, Université de Montréal. This article is a revised version of a paper prepared for the Comparative Capital Gains Taxation conference, Monash University, Prato, 26-28 September 2017. We thank the participants at the conference for their comments and the referee for useful suggestions.

1. INTRODUCTION

The taxation of capital gains in Canada was introduced in 1972, building on the Carter Commission recommendation of 1966 that this be done since ultimately it does not matter whether capital gains, gifts and bequests are or are not called 'income' (Royal Commission on Taxation (Carter Commission), 1966). What does matter is that these things increase the economic power of those who are fortunate enough to receive them, and therefore should be taxed like wages, salaries, rent, dividends, interest and so on (Carter Commission, vol. 3, part A, p. 25); or put differently 'a buck is a buck'.[1] The taxation of capital gains is in 2018 one of two taxes on wealth, or more precisely in this case an increase in wealth, in Canada; the other is the tax on real property-structures and land. Succession duties had been introduced by various provinces over the 1892-1905 period, while the federal government first imposed death taxes in 1941; these duties and taxes were abolished over the 1972-1985 period (Goodman, 1995).

This article will describe briefly the history of capital gains in Canada, then examine three selected aspects. These are: (a) the gradual shift from death taxes to capital gains taxes; (b) the effects of the short-lived Lifetime Capital Gains Exemption, and (c) the 2000 federal inclusion rates changes that were driven in part by a policy choice of Ontario. A brief discussion of the post-2000 status of capital gains taxation and a conclusion follow.

2. A BRIEF HISTORY OF CAPITAL GAINS TAXES IN CANADA

The Royal Commission on Taxation (the Carter Commission after the name of its chair, Kenneth Carter) was convened in the 1960s by the federal government; it produced a report that put forward various changes to the then existing tax regime. Prior to the publication of the report, capital gains in Canada were tax-free. Changes in 1972 to the *Income Tax Act* that implemented some recommendations of this Royal Commission brought about inclusion of 50% of realised capital gains in taxable income. This was intended to create a more progressive tax on income, since '[w]ages, salaries, business profits, gifts and capital gains all increase the economic power of the recipients and should be treated on exactly the same basis for tax purposes' (Beaubier, 1972, p. 560).

The 50% inclusion rate of realised capital gains in income subject to the personal income tax was in place from 1972 to 1987. Realisation occurred on the sale of the asset and was deemed to have occurred at death but with a tax-free rollover to a surviving spouse. In June 1987, the federal government announced that '[t]he inclusion rate — that is, the proportion of an individual's capital gain that is taxable — will be increased from the current rate of 50 per cent to 66 2/3 per cent in 1988 and to 75 per cent for 1990 and subsequent taxation years'.[2] This 75% inclusion rate was in place from 1990 to 2000 (February) when the federal Budget brought it down to 66.67%; it was further lowered to 50% in the government's October 2000 economic statement (Department of Finance, 2000b) and has remained unchanged since then. One other notable change in the taxation of capital gains was the introduction in 1985 of a lifetime capital gains

[1] Allegedly said by the Royal Commission chair Kenneth Carter: see Macdonald (2006). The buck was common term for the Canadian dollar, now replaced by the term 'the loonie' (not loony!). For more details see https://en.wikipedia.org/wiki/Canadian_dollar.

[2] This was part of a large set of tax changes including the first steps to introducing a value added tax (VAT, termed the goods and services tax (GST)) in Canada. See Wilson (1987, p. 34).

exemption (LCGE) for all taxpayers. Since 1995, it only remains available for small businesses, farmers and fishers.

As shown in Table 1, from 1972 to 2016 (the last year available at the time of writing), capital gains for both individuals and businesses have increased 174 times in nominal terms (and in real terms 30 times).[3] Table 2 shows that both the amount of taxable gains reported by individuals and the number of individuals reporting them also increased from 1972 to 2016.

Table 1: Importance of Capital Gains, by Amount, Canada, Ten Selected Years, 1972-2016 (CAD million, unadjusted for inflation)

Year	Individual	Business	Total
1972	176	89	265
1975	476	323	800
1980	2836	1896	4732
1985	2888	2615	5504
1990	8342	5930	14 272
1995	7471	6066	13 537
2000	20 465	11 491	31 956
2005	17 641	12 723	30 364
2010	16 814	14 218	31 032
2016	25 735	21 553	47 228

Sources: Statistics Canada, Financial and taxation statistics, enterprises and corporations, various series (Tables 33-10-0011-01, 33-10-0006-01 and 33-10-0016-01, formerly CANSIM Tables 180-0001, 180-0003 and 181-0001 respectively); Canada Revenue Agency, *Income tax statistics*, Table 2, various years.

[3] Using the CPI to deflate them: https://www.bankofcanada.ca/rates/related/inflation-calculator/?.

Table 2: Importance of Capital Gains, by Amount and Share, Individuals, Canada, Ten Selected Years, 1972-2016 (CAD '000, nominal and %)

Year	A Total capital gains from all sources	B Taxable amount of capital gains	C Number of payers reporting capital gains	D Capital gains, % of total taxable income	E % of taxpayers reporting capital gains	F % of tax filers reporting capital gains
1972	$ 351,897	$ 175,939	n.a.	0.9%	n.a.	n.a.
1975	$ 1,065,321	$ 476,213	n.a.	1.6%	n.a.	n.a.
1980	$ 5,944,367	$ 2,836,274	n.a.	n.a.	n.a.	n.a.
1985	$ 5,505,676	$ 2,887,888	594,163	2.9%	5.3%	3.7%
1990	$ 11,095,885	$ 8,341,904	626,050	2.1%	4.5%	3.3%
1995	$ 10,366,326	$ 7,471,180	1,003,660	1.6%	7.12%	4.9%
2000	$ 29,812,896	$ 20,465,006	2,409,800	3.3%	15.6%	10.8%
2005	$ 33,838,117	$ 17,641,493	1,023,750	2.4%	13.4%	9.2%
2010	$ 29,287,705	$ 16,814,504	1,564,530	1.9%	9.9%	6.6%
2016	$ 45, 479, 320	$ 25,734 ,582	2,583,870	2.3%	14.40%	9.7%

Source: Canada Revenue Agency, *Income tax statistics*, various years Table 2

Notes: Column A shows the total realised net capital gains from all sources and all income levels. Column B subtracts the allowable capital losses and presents taxable capital gains from all sources. Column C presents, when available, the number of payers reporting capital gains. Column D presents total taxable capital gains as % of total taxable income for that year. Column E is the % of tax filers and Column F the % of taxpayers who reported realised capital gains.

We now turn to the first of the three specific topics to be examined in some depth, which is the replacement of death taxes by capital gains taxation.

3. THE REPLACEMENT OF DEATH TAXES BY CAPITAL GAINS TAXATION

Death taxes began to be undermined before the introduction of capital gains taxation in Canada by decisions taken by the provinces of Alberta and Saskatchewan to reduce their death tax rates in part by rebating the federal amount paid out to them. However, the full disappearance of death taxes followed the introduction of capital gains taxation. This happened since one of the main purposes of the death tax was to act as a 'check' on the incomes of the wealthy and to make up for tax avoidance choices that were used throughout an individual's lifetime. But as Bird (1978, p. 138) noted, '[w]hen capital gains were taxed directly, as in the 1971 Act, there was much less need for death taxes for either revenue or "catch up"'. In order to avoid double taxation, with individuals seeing their capital gains taxed both throughout their lifetime and again upon their death, the abolition of death taxes and the introduction of capital gains taxation was carried out simultaneously at the federal level in 1972. At the provincial level, first Prince Edward Island then the other three Atlantic provinces did away with the succession duties. All provinces abolished succession duties in the 1970s except for Quebec, which eliminated the tax in 1985.[4]

Table 3 shows the federal and provincial succession duties revenues for five years in the 1965-1980 period. In 1972, federal revenues from capital gains taxation introduced that year were most likely of the same magnitude as federal succession duties[5] and exceeded them afterwards. Table 3 also shows the importance of two provinces in provincial succession duties and the impact on revenues with the drop from 1975 to 1980 of various provinces abrogating these duties in the 1970s. The dominant share of Québec in 1980 is explained by the fact that it was then the sole province still actively collecting succession (and accession in this case) duties while other provinces obtained revenues from the closing of past estates.

Table 3: Succession Duties, Canada, All and Two Largest Provinces, Five Selected Years, 1965-1980 (CAD million, current)

Year	Federal revenue	Provincial (all provinces) revenue	Ontario revenue	Québec revenue
1965	101	111	55	42
1970	111	155	78	50
1972	80	150	75	46
1975	6	150	73	39
1980	1	71	23	43

Source: Canada and all provinces: Statistics Canada, *Direct taxes, persons*, Table 36-10-0178-01 (formerly CANSIM Table 380-0543); Ontario and Québec: Statistics Canada, Direct taxes, persons, provincial accounts, Table 36-10-0337-01 (formerly CANSIM Table 384-0027).
Note: Ontario and Québec are included in the provincial total.

[4] The Parti Québécois, in power in Quebec from 1976 to 1985, was a self-described social democrat party that believed in death taxes as a redistributive measure. It thus abolished the taxes only in early 1985 after a change in Finance minister.
[5] Direct data on the yield resulting from the inclusion of capital gains in the personal income tax base is not available as it is not a standalone tax. But Table 2 above indicates individual taxable capital gains of CAD 175 million that, if taxed at an average tax rate of 50%, would yield CAD 90 million of tax revenue.

We now turn to the birth and death of the lifetime capital gains exemption.

4. Lifetime capital gains exemption

The federal government introduced the generally available lifetime capital gains exemption (LCGE) in 1985 with the following aims (Department of Finance, 1985, p. 3):

> The budget proposes a major initiative to encourage risk-taking and investment in small and large businesses and to assist farmers by providing a cumulative tax exemption for capital gains up to a lifetime limit of $500,000. This change will support equity investment and broaden participation by individuals in equity markets. In addition, it will improve the balance sheets and financial health of Canadian companies. It will provide a tax environment that is more conducive to high technology companies raising capital. It will encourage individual Canadians to start new businesses and will help small businesses grow. The number of individuals benefiting from the exemption will depend on the response of individual Canadians.

The exemption was to be phased in over a period of six years with a cumulative limit of $250,000 in taxable capital gains in the sixth and subsequent years. The phasing-in was planned as follows: $10,000 in taxable gains in 1985; $25,000 in 1986; $50,000 in 1987; $100,000 in 1988; $150,000 in 1989; and $250,000 in 1990 and thereafter. In 1987, the federal government ended the growth of the LCGE (Department of Finance, 1987, p. 11) thereby halting the cumulative limit at CAD 100,000 of capital gains with the exceptions noted below; this was part of the changes that were put forward 'to broaden the tax base, increase fairness and help finance personal income tax rate reductions'.

However, the original LCGE maximum for farmers, fishers and small businesses remained in place, reaching its planned maximum of CAD 500,000 in 1990. This maximum was increased to CAD 750,000 in 2007 and then to CAD 800,000 in 2014. In 2015, this amount was indexed to inflation for small business shares (SBC) and set at CAD 1,000,000 for farmers and fishers; the SBC amount indexed to inflation is worth CAD 848,252 in 2018 while the CAD 1,000,000 amount is not indexed to inflation but cannot be lower than the SBC amount.[6] The sole justification provided for this new differentiated treatment is 'to allow farm and fishing business owners to maintain more of their capital for retirement' (Department of Finance, 2015, p. 122).

The federal government eliminated the generally available LCGE in 1994 (Department of Finance, 1994, p. 42). In 1994, one could mark up the value of capital assets without selling them in order to use up any unused LCGE space; thus one used accrued capital gains rather than realised capital gains for this. This explains the extremely high tax expenditure of CAD 8,815 million associated with the generally available LCGE in 1994, which will be shown in Table 6 in section 4.3 below.

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[6] See Taxtips.ca, 'Lifetime capital gains exemption (LCGE)', https://www.taxtips.ca/smallbusiness/capitalgainsdeduction.htm.

Three dimensions of LCGE are now examined: (a) its impact on investment; (b) its impact on retirement income, and (c) its relationship with the distribution of income.

4.1 The impact of LCGE on investment

The generally available LCGE lowered the effective amount of capital gains subject to taxation. McKenzie and Thompson (1995) examined the effects of the exemption on the cost of equity financing of corporations in order to evaluate the impact of the generally available LCGE on investment. Their model is based on the neoclassical investment theory whereby a firm will maximise profits by investing at the level where the user cost of capital is equal to the marginal product of capital.

The study by McKenzie and Thompson (1995) examined two samples of stocks listed on the Toronto Stock Exchange in order to control for industry and firm-specific bias. Sample 1 was all stocks (270) listed on the Toronto Stock Exchange; sample 2 was a subset made up of firms with both preferred and common shares listed (51, and thus 102 shares); the authors expected a greater impact of the LCGE on common than preferred shares. They then used the impact on the cost of capital and elasticities found in the literature linking this cost to real investment to ascertain the impact of the LCGE. They concluded that:

> [i]t is therefore difficult to draw strong conclusions about the effect of the capital gains exemption on the cost of capital and, therefore, on investment. Our estimates suggest that the increase in investment spending may have been negligible or as high as 6 per cent. More research is required before we can decide the issue with more confidence (McKenzie & Thompson, 1995, p. S113).

Since the study was conducted using companies listed on the TSE 300 the results cannot be applied to small businesses that are not listed on the stock market, and therefore the impact that the LCGE could have on encouraging investment in small business is not fully captured. However, a lifetime capital gains exemption that generally applies to all assets is an inefficient means of stimulating small business investment (Mintz & Richardson, 1995).

4.2 LCGE and retirement savings of farmers and small business owners

One argument used to justify the LCGE is that farmers and small business owners (SBOs) cannot save for retirement as easily as salaried workers. The two main tax advantageous savings vehicles for retirement in Canada are the individual owned Registered Retirement Savings Plan (RRSP) and the employer-sponsored Retirement Pension Plan (RPP). Both allow deducting from taxable income the allowable contribution of the taxpayer and sheltering from personal income tax until withdrawal (required at age 71; it was 69 from 1996 to 2007) the returns to capital. But farmers and SBOs are often reinvesting their earning in their businesses and thus cannot easily make use of RRSPs and rarely have access to an RPP. Their wealth is largely held in less liquid assets that would be sold to fund their retirement. Since the profit from such a sale constitutes a capital gain they could be taxed more heavily on their retirement funds than the majority of Canadians without the LCGE.

Jog and Schaller (1995) examined the retirement-related tax choices of farmers and SBOs using a sample of tax returns made up of three groups: farmers, SBOs and the general public. They did this for the 1982-1990 period, thus covering pre- and post-LCGE years. In the case of farmers, they noted:

> In principle, one might imagine that the farm LCGE was a substitute for the tax preference for retirement savings available to the general public. This does not appear to be the case in practice. Almost as large a proportion of the beneficiaries of the farm LCGE (23%) made an RRSP contribution as did the individuals in our full sample (30%)… Moreover, for all age groups, the average (farmer) RRSP contribution was at least 85 per cent as large as the average RRSP contribution for the typical individual in our full sample. For old beneficiaries (and the majority of beneficiaries were old), the average (farmer) RRSP contribution was 24 per cent higher than that for the typical individual in our full sample (Jog & Schaller, 1995, p. S148).

Thus the evidence does not support the argument that farmers cannot make use of RRSPs.

This is also the case for SBOs since:

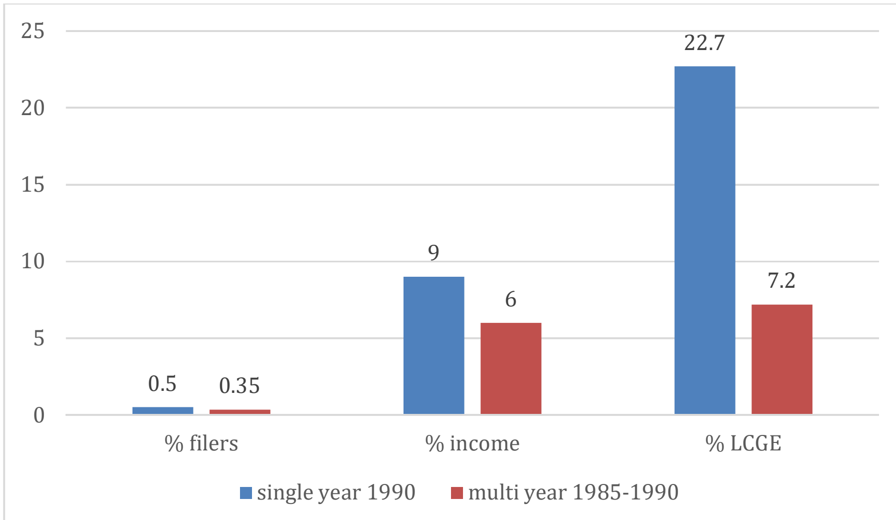
> …the majority of small business LCGE was claimed by people who were not at or near retirement age. Almost three-quarters of small business LCGE was accounted for by high income individuals. The average income of these individuals was about five times as large as that of the typical individual in our full sample. Finally, about three-fifths of small business LCGE was claimed by people who made high contributions to two other programs (namely RPPs and RRSPs) which offer tax preferences for retirement savings. Even the low contributors had an average income which was substantially higher than the typical individual in our full sample. This cast some doubt on the idea that low income prevented them saving for retirement (Jog & Schaller, 1995, p. S157).

Overall one can conclude from the work of Jog and Schaller (1995) that the LCGE often served as a complement to retirement savings for small-business owners and 'middle' to 'high income' farmers but did benefit 'low income' farmers.

4.3 LCGE and income distribution

Davies (1995) examined the use of the LCGE by income group using both a one-year (1990) and a multi-year (1985-1990) perspective. One-year results showed a greater concentration of the LCGE in upper income groups than multi-year results. Figure 1 illustrates this for the highest income group. This is similar to the findings of Jog and Schaller (1995) discussed above.

Fig. 1: Three Tax Indicators: Proportion of Canadian Tax Filers, Income and LCGE (%, single and multi years) in the top income group

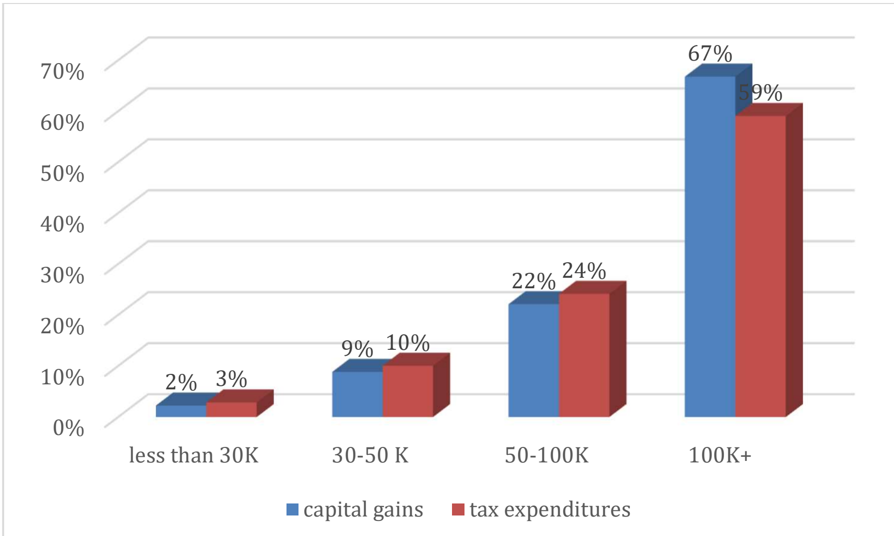


Source: Davies (1995, table 7 p. S168); see also Table 7 below.

Note: Top income group is 250 000 $ + (CAD)

Overall the evidence discussed above shows that the LCGE is not a very useful policy tool. Yet it reduces the revenues of the federal and provincial governments. Mintz and Wilson (1995) present evidence on the tax expenditure associated with the LCGE; it increased from CAD 394 million in 1985 to CAD 1,532 million in 1991 (Mintz & Wilson, 1995, p. S180). They also present evidence on the tax expenditure by income group; we focus on 1991 in Figure 2. It shows a high concentration in the two higher income groups.

Fig. 2: Share of Capital Gains Amount and LCGE Tax Expenditure for Four Income Groups, 1991 (%)



Source: Mintz and Wilson (1995, p. S180, Table 4) and calculations by authors.

Given the content of this section, we present updated relevant information in Tables 4 to 8.

Table 4 shows the relative importance of capital gains in capital income for all Canadians. It shows an almost fivefold increase in the share of capital gains in capital income from 1972 to 2016. Table 5 shows the shares of capital gains reported by the top income earners in Canada for the same period. Capital gains have become more concentrated over time in the hands of the top income group.

Table 4: Importance of Capital Gains in Capital Income, Canada, Six Years, 1972-2016 Interval (CAD million, current)

Year	Capital gains	Capital income	% capital gains in capital income
1972	149	2,913	5.1%
1980	2,750	21,531	12.8%
1990	8,341	49,241	16.9%
2000	20,465	56,251	36.4%
2010	17,533	81,563	21.5%
2016	27,735	108,545	23.7%

Source: CRA, *Income tax statistics*, various years.

Note: Capital income is the sum of capital gains, dividends and interest earned by individuals.

Table 5: Importance of Capital Gains, Top Income Group, Canada, Six Years, 1972-2016 Period

Year	A % of total capital gains reported by top income group	B % capital gains in capital income of the top income group	C Share of income of the top income group in total income
1972	8.4%	8.6%	0.2%
1980	3.7%	3.7%	1.4%
1990	31.6%	13.8%	4.6%
2000	45.6%	52.5%	9.1%
2010	49.9%	8%	10.2%
2016	50.8%	35.0%	10.0%

Source: Canada Revenue Agency, *Income taxation statistics*, various years. Note: The first column, A, represents the share of capital gains recorded by filers in the top income group. Column B represents the share of capital gains in the financial income of members of the top income group. Column C shows the share of income assessed for members of the top income group as a percentage of total income assessed. The threshold of CAD 200,000 defined the top income group until 1985 when it was increased to CAD 250,000 and has not changed since.

Table 6 presents the relative importance in terms of tax expenditures of the various components of the LCGE over time. The year 1988 is the first with the full-fledged LCGE available and 1994 the year of its abolition. Table 7 examines in some detail the capital gains tax expenditures associated with the personal income tax, highlighting the importance of the non-taxation of gains associated with the sale of the principal residence. Finally, Table 8 presents information on the tax expenditures associated with the capital gains subject to the corporate income tax.

Table 6: Tax Expenditure from LCGE Exemption, Individuals, Selected Eight Years, 1988-2015 Interval, Canada (CAD million, current)

Year	A General LCGE*	B Farmers	C Small Business	D Total
1988	855	225	415	1,495
1990	755	290	580	1,625
1994	8,815	470	1,725	11,010
1995	34	275	590	899
2000		325	740	1,065
2005		255	430	685
2010		325	540	865
2015		620	775	1,395

Source: Department of Finance, Canada: *Report on Federal Tax Expenditures*. Note: the generally available LCGE was terminated in 1994.

Table 7: Capital Gains, Personal Income Tax Expenditures, Main Items and Total, Canada, Six Years, 1990-2015 Interval (CAD million, current)

Year	A LCGE exemption	B Non-inclusion of capital gains on principal residence	C Partial inclusion of capital gains	D Total expenditure*
1990	1,625	2,390	695	4,710
1995	899	1,085	405	2,389
2000	1,065	1,000	2,500	4,565
2005	685	3,465	2,840	6,630
2010	865	4,105	3,630	8,600
2015	1,395	6,195	5,755	13,345

Source: Department of Finance, Canada: *Report on Federal Tax Expenditures*, various years.
* This column, author calculations. Total does not include tax expenditures associated with numerous small capital gains; these amount to less than CAD 100 million in 2015.

Table 8: Capital Gains, Corporate Income Tax Expenditures, Canada, Six Years, 1990-2015 Interval (CAD million, current)

Year	A Partial inclusion	B Refundable capital gains for investment and mutual funds corporations	C Total*
1990	417	81	498
1995	595	150	745
2000	2,465	645	3,110
2005	4,210	345	4,555
2010	3,285	185	3,470
2015	5,890	1,000	6,890

Source: Department of Finance, Canada: *Report on Federal Tax Expenditures*.

* This column, author calculations. Total does not include tax expenditures associated with numerous small capital gains; these amount to less than CAD 100 million in 2015.

We now turn to the evolution of inclusion rates in 2000.

5. CHANGES IN 2000 IN THE INCLUSION RATE OF CAPITAL GAINS

Let us first recall that the inclusion rate had been 50% from 1972 to 1988 when it became 2/3rds; as announced in 1986, it went up to 75% in 1990. Vaillancourt, Kerkhoff and Godbout (2018,table 3) show that in both years before the increased inclusion rate there were higher capital gains realisation than in the year of the increase. he 2000 February federal Budget (Department of Finance, 2000a, p. 94) proposed a decrease in the personal capital gains inclusion rate from 75% to 66 2/3% effective from that time to ensure 'that businesses have access to the capital they need in an economy that is becoming increasingly competitive and knowledge-based'. This brought the inclusion rate back to what it was before 1990. But this did not settle the overall inclusion rate for 2000. The Ontario government proposed a more important decrease in the capital gains tax inclusion rate under its provincial income tax than the February 2000 federal Budget. The May 2000 Ontario Budget (Ministry of Finance, Ontario, 2000, p. 88) established a schedule for the inclusion rate to decrease from the then current 75% to 66 2/3% immediately and then to 62% in 2001, 58% in 2002, 54% in 2003 and 50% in 2004.

Grady (2000) argued that this decrease altered the definition of income – which is not permitted under the Canada Revenue Agency guidelines for the collection of the provincial tax-on-income – but more importantly acted as a gateway to further reductions in the rate until the elimination of the tax altogether. Drache (2000) feared that the government could reintroduce succession duties to make up for declining capital gains taxes revenue. While Grady recognised the productivity and investment benefits linked with lower rates on capital gains, he found that it would not be equitable for Canadians, as investors would choose to move their investments into the lowest provincial tax jurisdiction. This, Grady (2000) concluded, was the beginning of a 'Balkanization' of Canada as the provinces each compete for investors by creating favourable tax environments for investment.

The 2000 Ontario Budget caused, implicitly if not explicitly, the federal government to rethink their policy on capital gains. This a rare instance where the proposed tax policy of a Canadian province has affected federal tax policy so directly and so quickly. In October of 2000, the federal Finance Minister announced in his 'mini- budget' that the federal Budget would further decrease the personal capital gains inclusion rate from 66 2/3% to 50% (Department of Finance, 2000b). It also increased the capital gain rollover available to small businesses. These changes were proposed with the intent of boosting investment and productivity in the small business sector while also assisting small businesses in savings, though it complicated tax filing in 2000. Taxpayers had to match the realisation date to the inclusion rate, i.e., 75% from 1 January 2000 until 1 February 2000, 66.67% from 2 February 2000 to 17 October 2000, and 50% for the rest of the calendar/personal income tax year.

These changes in the inclusion rate took place both in a specific context and as part of a more general debate on capital gains taxation. We first present the specific context of the federal and Ontario reforms and then turn to the general debate.

5.1 Federal context of the 2000 reforms

In the case of the federal government, a structural Canadian budget deficit appeared in 1973 but became an important policy and political issue only in the early 1990s with credit watch warnings and comparisons of the Canadian $ with the Mexican peso.[7] The federal government Budget of 1995 introduced cuts in transfers to provinces, unemployment insurance, defence and international aid that eliminated the deficit in 1997 and generated surpluses until 2008. The use of these annual surpluses became an object of public policy debate. Mintz and Wilson (2000) and Robson, Mintz, and Poschmann (2000) proposed a reduction in the capital gains tax inclusion rate from 75% to 66 2/3%. Their reasoning was that businesses can distribute income in the form of capital gains (implicitly) or dividends (explicitly). The dividend tax credit found in the personal Income Tax Act resulted in dividends receiving a more favourable tax treatment than capital gains when the inclusion rate of capital gains in taxable income was 75%. A reduction in the inclusion rate would create a more balanced relationship between the two types of income in terms of their tax treatment.

5.2 Ontario context of the 2000 reforms

Turning to the Ontario context, it suffered in 1990-1995 low economic growth caused in part by economic difficulties associated with the introduction of the Canada-United States Free Trade Agreement (CUFTA, the predecessor of the North American Free Trade Agreement (NAFTA) of 1994). The left-leaning provincial New Democratic Party (NDP) government in power then chose to incur deficits and thus increase public debt to stimulate the economy. The election of the right-leaning Progressive Conservative (PC) government in 1995 was associated with policies reducing the size of the provincial government and thus provincial taxes. One demand of this government was for more autonomy in collecting provincial personal income taxes. From the mid-1950s onward to 2000 (Bird & Vaillancourt, 2006), provinces other than Québec (which collects its personal income tax itself) taxed personal income through the application of a surtax on the basic federal income tax ('tax on tax') and then adjusted this amount through various surtaxes, or tax credits (Guimond & Vaillancourt, 2013). The federal government administered both federal and provincial personal income taxes free of charge with only one tax form for taxpayers to fill out. However, this system gave provinces little leeway in setting the progressivity of their personal income tax as they had to use the structure of the federal income tax – the number of brackets, range of each bracket and federal tax rates – as a building block. Due to the constraint of the 'tax-on-tax' system, Ontario threatened to follow in the footsteps of Québec and collect its own personal income tax. The federal government responded to this by allowing provinces to elect to switch to a 'tax-on-income' system, thus giving the provinces the freedom to determine their own number of tax brackets, the range of each bracket and their respective rates; they were still to be required to use the same definition of taxable income as the federal government to maintain the collection arrangements.

5.3 The general debate

Having presented the two specific contexts, we now turn to the general debate on taxing capital gains. In summary fashion, it can be noted that proponents argue that the progressivity of the taxation of capital gains and its ability to capture income that may not have been normally included in the taxation on personal income make such taxation indispensable. By contrast, opponents such as Clemens, Lammam and Lo (2014) cite

[7] See, e.g., Thomas Courchene, 'Half-way home: Canada's remarkable fiscal turnaround and the Paul Martin legacy', Institute for Research on Public Policy, 3 July 2002, http://irpp.org/research-studies/half-way-home/ (accessed 19 December 2018).

numerous flaws in the system: (a) incentives to not sell investments rather than reallocate and reinvest; (b) a negative impact on investment and entrepreneurial activity in Canada and movement of capital in the international market; (c) its inability to adjust for inflation or temporary income shocks, and (d) its collection cost. These can be considered in greater detail as follows.

1) In the presence of capital gains taxes, investors are likely to postpone reallocation of assets until the return differential is sufficient to offset the capital gains taxes imposed on the disposal of assets (Abeysekera & Rosenbloom, 2002). This phenomenon, known as the 'lock-in effect', reduces the amount of capital being reallocated and reinvested. Reductions in the tax rates on capital gains reduce the investment capital locked-up as the cost of switching decreases.

2) Capital gains taxes pose a significant concern for those looking to invest in small businesses and start-ups as the reward given to investors and venture capitalists for their risk often lies in equity shares of the new company. Reductions in the capital gains tax rate may ease the concerns investors have of locking-in their investment for long periods of time and allow them to invest more often and in riskier projects without fear of their money being stuck in a business that did not pan out.

In the same vein, proponents of the reduction of the rate of capital gains taxes often refer to the changing position of Canada in the international investment market. As other Organisation for Economic Co-operation and Development (OECD) countries reduce their rates on capital gains, Canada moves from being an average-taxed country to a high-taxed country. Comparisons between Canada and the other OECD countries as well as between Canada and the United States often resulted in Canada being deemed less attractive for foreign investment. The fear was that having higher costs of capital may cause foreign investors and even Canadians to look to invest their money elsewhere.

3) A third issue is the failure of the capital gains taxes in Canada to account for inflation. The concern is that because the initial capital cost is not indexed to inflation, those paying the tax on realised gains are paying taxes on an increased value owing partially or entirely to inflation and not to an increase in the real value of the asset. Some countries have solved this by including a consumer price index table in their tax returns and allowing filers to multiply the value of their assets by the inflation index to find the true value of the gains. This issue is exacerbated by the 'bunching effect' since the realisation of a capital gain may temporarily place a taxpayer into a higher tax bracket and therefore not accounting correctly for an individual's lifetime ability to pay.

4) Finally, the receipt of capital gains income generates higher compliance costs for taxpayers than government transfer payments or wage income but lower compliance costs than for self-employment or rental income (Vaillancourt, Roy César & Silvia Barros, 2013, Table 4b).

6. THE WAY FORWARD

Since 2000, there has been little change in the treatment of capital gains in Canada. Tables 9 and 10 present information respectively on the geographic distribution of capital gains and on their importance for the three richest group of taxpayers. Table 9 shows a fairly stable distribution of the number of tax filers with taxable capital gains and of their value across the five regions of Canada; noteworthy is that in the East

(Atlantic provinces, Québec and Ontario) the share of gains is smaller than the share of tax filers while in the West (prairie provinces and British Columbia) the reverse is observed. Table 10 shows a growth in the share of capital gains in the hands of the three top income groups; in 2014, 75% of capital gains were in the hands of these three groups that account for 23% of tax filers. This concentration has increased since 2005 due in part to inflation,[8] and is seen by some as a possible target for a federal government that introduced a new maximum personal income tax rate of 33%[9] shortly after its election (October 2015). In the lead up to the federal budget of 2017, various commentators indicated that they feared an increase in the inclusion rate of capital gains,[10] but it did not materialise. One of three measures put forward in July 2017 to increase tax fairness between the self-employed and wage earners was to make it more difficult to convert the income accumulated in small corporations into capital gains or to use more than one LCGE to extract it from the business.[11] Negative reactions from small business associations[12] and the medical community (see Canadian Medical Association, 2017) were very strong; the minister dropped this aspect of his reform in October 2017.

[8] Of 18.9% over the period: http://www.bankofcanada.ca/rates/related/inflation-calculator/.
[9] This was done by adding a fourth bracket for those with taxable income above CAD 202,000; the highest rate previously was 29%.
[10] For a good discussion of this issue, see Golombek (2017); Grant Thornton (2017).
[11] For a presentation of the document entitled 'Tax Planning Using Private Corporations', see Department of Finance (2017).
[12] For example https://www.cfib-fcei.ca/sites/default/files/article/documents/5648.pdf.

Table 9: Share of Capital Gains, by Region, Number of Tax Filers and Value, Canada, 2005, 2010 and 2015 (%)

	A Atlantic		B Quebec		C Ontario	
Year	**Number**	**Value**	**Number**	**Value**	**Number**	**Value**
2005	4.7%	3.3%	20.1%	14.8%	40.8%	37.6%
2010	4.3%	2.7%	21.2%	17.6%	39.5%	35.9%
2015	4.4%	3.12%	19.2%	17.9%	42.3%	38.64%
	Prairie		**British Columbia**		**Canada**	
	Number	**Value**	**Number**	**Value**	**Number**	**Value**
2005	18.8%	24.1%	15.1%	18.4%	99.5%	98.3%
2010	18.8%	23.2%	15.5%	18.0%	99.4%	97.33%
2015	18.04%	1.9%	15.9%	18.0%	99.5%	99.9%

Source: Canada Revenue Agency, *T1 Final statistics*, Table 5, 2017, 2012, 2007.
Note: The Canadian total is not equal to 100% since tax filers from the Northern territories and those living abroad are not included in this Table.

Table 10: Share of Capital Gains, Top Three Income Groups (CAD), by Number and Value, Canada, 2005, 2010 and 2015 (%)

Yr	100,000 – 149,999		150,000 – 249,999		250,000+	
	Number	Value	Number	Value	Number	Value
2005	7.4%	9.9%	3.9%	11.9%	3.3%	46.6%
2010	10.3%	10.9%	5.9%	13.0%	4.6%	49.9%
2015	11.2%	10.3%	6.4%	12.5%	4.7%	51.8%

Source: Canada Revenue Agency, T1 Final statistics, Table 5, 2017, 2012, 2007.

7. Conclusion

This article presented a brief history of the taxation of capital gains in Canada. It shows how capital gains taxation through their partial inclusion in taxable income replaced the death taxes in the 1970s, how capital gains tax revenues were reduced for a short period by the introduction of a general lifetime capital gains exemption (LCGE) in the 1980s but then bolstered by the narrowing of this exemption and by an increase from 50% to75% of the inclusion rate in the 1990s. It also examines how in a federal country a specific tax choice of its largest constituent unit (Ontario in 2000) was quickly followed by a change in federal tax policy. While capital gains taxation in Canada clearly could be improved mainly through indexing to account for inflation in the calculation of taxable gains, in its current form it plays a role in ensuring tax fairness in Canada.

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