INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

Needed Reforms to Canada's Capital Gains Tax Framework:
IIAC Recommendation to the House of Commons Standing Committee on Finance

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Executive Summary

Taxes on investment income impact the orderly functioning of capital markets. The IIAC identifies Canada's current framework for capital gains tax as a major impediment to the supply of risk capital for productive investment, particularly for small and medium sized enterprises (SME) and start-up businesses. The current high rate of tax on capital gains discourages the flow of scarce investment capital by deterring investment in high risk projects and is an impediment to the transfer of capital to more productive investment. **A reduction in capital gains tax, we believe, will result in greater business and job creation, enhanced productivity and economic activity and overall wealth creation and prosperity for Canadians.**

We recommend that the guiding principles behind the capital gains tax reform should be:

- Remove or amend policies that distort business decisions through incentives that discourage small business from growing into mid-sized operations.

- Promote the mobility of capital to ensure the efficiency of marketplaces and to maximize investor financial returns.

- The framework should be kept as fair and simple as possible.

Specifically, our Association recommends the reduction of capital gains taxes by either:

1. Reducing or eliminating the current 50% inclusion rate for capital gains.

2. Extending the life-time capital gains exemption currently only available on the disposition of qualified small business corporation shares (and farm property) to publicly listed shares of small companies.

3. Adopting the capital gains tax proposal contained in the 2006 Conservative Party federal election platform which proposed that capital gains earned by individuals on real and financial assets be exempt from taxation if the proceeds were reinvested within a six-month period.

11 King Street West, Suite 1600, Toronto, Ontario M5H 4C7
Tel.: 416. 865.3036 • irussell@iiac.ca • Fax: 416.364.4861 • www.iiac.ca

Why Capital Gains Tax Reform is Needed

Several arguments exist as to why policy makers need to re-examine Canada's current framework for capital gains taxation. We identify the following:

Capital Gains Taxes Impact Capital Formation

The tax system can provide an incentive for risk-taking and stimulate capital formation by embracing policies that increase the investor's after-tax return on investment. When analyzing an investment decision, it is the after-tax *real* rate of return that matters to investors. A lower rate of capital gains tax results in a higher after-tax return which encourages investment in risky enterprise by compensating for additional risk. With reduced capital gains taxes, investors will be more inclined to invest in riskier investment or pay more for equity shares leading to an increase in share price. Higher share prices result in less expensive equity financing and a lower average cost of capital for the corporation. A lower cost of capital means that additional projects would be viewed as profitable by corporations, prompting an increased willingness by the corporation to invest in riskier projects. A lower capital gains tax also encourages investment in growing corporations that reinvest their profits back into the business and the economy. A lower rate of capital gains tax therefore stimulates capital investments on the part of individuals and corporations, and promotes capital formation, risk-taking and entrepreneurship. This, in turn creates jobs, increases productivity and economic output.

Capital Mobility

Global capital investment flows respond to differentials in capital gains taxes because of the tax impact on investment returns. Technology and information access, and liberalized regulation, has unleashed capital into an increasingly integrated global marketplace. As a result, jurisdictions compete for this mobile capital by implementing competitive tax regimes for capital and income. Canada risks falling behind and not reaping the potential benefits from access to foreign capital. Despite recent further reductions in rates, Canada's tax system remains less competitive compared with the U.S. and countries within the European Union. This is most evident for capital gains taxes. In Canada, the top marginal tax rate for an individual's capital gains is as high as 24% in some provinces, compared to 15 per cent on long-term capital gains in the United States.

Top Marginal Tax Rates for Individuals for 2007 (%)

	Salary & Interest	Capital Gains	Eligible Dividends	Non-eligible Dividends
British Columbia	43.7	21.9	18.5	31.6
Alberta	39.0	19.5	17.5	25.2
Saskatchewan	44.0	22.0	20.4	30.8
Manitoba	46.4	23.2	23.8	36.7
Ontario	46.4	23.2	24.6	31.3
Quebec	48.2	24.1	29.7	36.4
New Brunswick	47.0	23.5	23.2	35.4
Nova Scotia	48.3	24.1	28.4	33.1
P.E.I.	47.4	23.7	24.4	33.6
Newfoundland	47.0	23.5	30.6	35.6

Source: KPMG

Capital Gains Taxes Lead to Market Inefficiencies

High capital gains taxes obstruct the flow of risk capital to more productive investment. The current capital gains framework distorts investor decision-making. For example, a Canadian investor contemplating liquidation of an equity portfolio to reinvest into better performing assets may decide not to unlock these gains when considering the tax consequences, thereby preventing investors from seizing attractive investment opportunities.

Capital gains tax is also inefficient to the extent that it penalizes rather than reward those who save. Those who choose to save and invest pay tax on income derived from those investments – hence a form of double taxation. This discourages Canadians from saving while promoting consumption.

Current Framework Disadvantages Growing Small Businesses

The current policy framework provides a lifetime capital gains exemption for individuals of up to $750,000 for gains from the disposition of qualified small business corporation shares. Additionally, small business investors benefit from the capital gains rollover provision which enables individuals to defer tax on capital gains from small businesses as long as the proceeds are reinvested in another eligible small business. These are important provisions that promote innovation and growth by making it easier for small businesses to access desperately needed risk capital. However, because these provisions are associated with asset thresholds, they disadvantage small businesses that grow beyond the thresholds. As a consequence, this framework distorts the decisions of shareholder managers who choose to stay below the asset threshold to maintain the benefits of these provisions[1]. Consideration should be given to increasing or eliminating the asset threshold and to expand the definition of qualified small businesses to include small publicly listed companies trading on a recognized Canadian marketplace.

Tax-Free Savings Accounts Are Not Enough

The federal government surprised most policy watchers by announcing the introduction of tax-free savings accounts (TFSAs) in the February 2008 budget. The IIAC supports the introduction of TFSAs as they will boost savings, although modestly in the initial years of the program, and over time will provide an effective vehicle to generate tax-sheltered dividend and interest income, and capital gains. Even though TFSAs will have small portfolio impact, we anticipate investors will incorporate these savings instruments as an integral component in investment and tax planning strategies. While the new TFSAs will promote increased savings, albeit modestly given the small tax incentive, these tax-assisted accounts are not a substitute for a vigorous tax incentive to promote and encourage risk investment in the Canadian economy. Access to scarce capital to fund risk investment, particularly the equities of small and mid-sized businesses, is the key to capital formation, global competitiveness and economic growth. Increased savings through TFSAs will not necessarily flow to risky investments. Lower capital gains tax rates are the most effective mechanism for unlocking capital and stimulating the flow to productive investment.

[1] *Clearing Hurdles: Key Reforms to Make Small Business More Successful*, Ben Tomlin, C.D. Howe Institute

IIAC Recommendation

In order to bolster productivity and economic growth in Canada, policymakers must make changes to the current framework for the taxation of capital gains. The guiding principals behind the tax reform should be:

- Remove or amend policies that distort business decisions by creating incentives that discourage small business from growing into mid-sized operations.

- Promote the mobility of capital to ensure the efficiency of marketplaces and to maximize investor financial returns.

- The framework should be kept as fair and simple as possible.

Where possible, tax policy must be kept administratively simple in order to reduce time, costs, and frustrations for taxpayers and intermediaries. With this in mind, we recommend the most straightforward approach to address deficiencies with the current capital gains framework is by drastically reducing the current inclusion rate or eliminating capital gains taxes altogether. At a minimum, the current capital gain provisions eligible for qualified small business, including the $750,000 exemption and the roll-over should be expanded to include growing small companies that have surpassed the current prescriptive asset thresholds and have gone public on a recognized Canadian marketplace.

Alternatively, the IIAC also believes the capital gains proposal put forth by the Conservative Party in their 2006 election platform, if structured properly, also merits your consideration. Their framework proposed that capital gains earned by individuals on real and financial assets be exempt from taxation if the proceeds were reinvested within a six-month period.

The forgoing recommendations would have a positive impact on capital formation and productivity in Canada. The reduction or elimination of capital gains tax would encourage investment in riskier opportunities and induce investors to unlock invested capital and redirect the investments to new opportunities in public and private markets. Recent evidence in the United States demonstrates that steep reductions in effective capital gains tax rates stimulates the flow of scarce capital to new investment opportunities. Further, tax revenues increased as higher tax revenue from increased transactional flow offset the impact of the lower tax rate. In our view, any of these recommendations would contribute importantly to reversing the relative decline in productivity and competitiveness in the Canadian economy.

Cost to Government

The Department of Finance's most recent *Annual Tax Expenditures and Evaluations Report,* shows that the cost to the federal government stemming from the current partial inclusion of capital gains is approximately $10 billion.[2] This represents just 4% of total budgetary revenues. Reducing or eliminating capital gains taxes or providing for a capital gain roll-over provision may likely not have a meaningful impact on government coffers and may actually increase overall tax revenues stemming from further business and job creation, increased capital spending, corporate income and profits, and investor wealth.

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[2] Tax Expenditures and Evaluations 2007 (http://www.fin.gc.ca/taxexp/2007/taxexp2007e.pdf) Table 1 shows 2007 projections of $5.06 billion under personal income tax expenditures for partial inclusion of capital gains and Table 2 shows projections of $5.065 billion under corporate income tax expenditures related to partial inclusion of capital gains.

The Time is Right

The fiscal position of the Canadian government has improved vastly. The accumulated deficit now represents only an estimated 33 per cent of GDP compared to over 60 per cent ten years ago – while appreciating measures announced by the Finance Minister in his Economic Statement on October 30, 2007 and in the most recent federal budget, we believe the federal government still has ample room to deliver broad-based tax relief that, if structured properly, will bolster productivity, while still enabling the government to meet debt reduction targets.

Ian C.W. Russell
President
Investment Industry Association of Canada
11 King St West, Suite 1600
Toronto ON
M5H 4C7

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