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VIEWPOINT

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INCREASING THE CAPITAL GAINS INCLUSION RATE: A TAX HIKE ON INVESTING AND ENTREPRENEURSHIP

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In its April 2024 budget, the federal government announced its intention to increase the capital gains inclusion rate from one half (50%) to two-thirds (66.67%), effective June 2024.[1] Not only does this apply to all gains made by corporations and trusts, but it also applies to capital gains of over $250,000 for individuals. Such a change has been proposed from time to time over the years, but now it has been implemented, and the Quebec government has decided to follow suit.[2]

Such a measure will be detrimental to the country's economy, and more importantly, to the living standards of all Canadians. For one thing, it not only affects the "rich," but will negatively impact small business owners like plumbers, electricians, and doctors, as well as small-scale real estate investors like duplex owners who have based their retirement plans on these lifelong investments.[3] Moreover, increasing capital gains taxation has a negative impact on venture capital investment and entrepreneurship, both of which are essential for innovation and economic growth.[4]

DISCOURAGING VENTURE CAPITAL INVESTMENT

Every year, a large number of businesses enter the market in Canada. For instance, in Quebec alone, over 22,000 opened their doors in 2020, despite the pandemic.[5] But the business entry rate, a standard measure of entrepreneurship, averaged 12.2% in 2020 across Canada, a 9% drop since 2014.[6] New businesses big and small require a lot of capital in order to achieve success and stability in their early stages. Alphabet, Apple, Amazon, and many other business giants depended on venture capital to raise funds before going public.[7]

Venture capitalists, who specialize in investing in start-ups, also provide advice and managerial support, which are key for the success of new businesses over time. The gains investors eventually make are then taxed once shares or ownership stakes are sold. In 2023, C$6.9 billion dollars were raised in the Canadian venture capital market through 660 deals.[8]

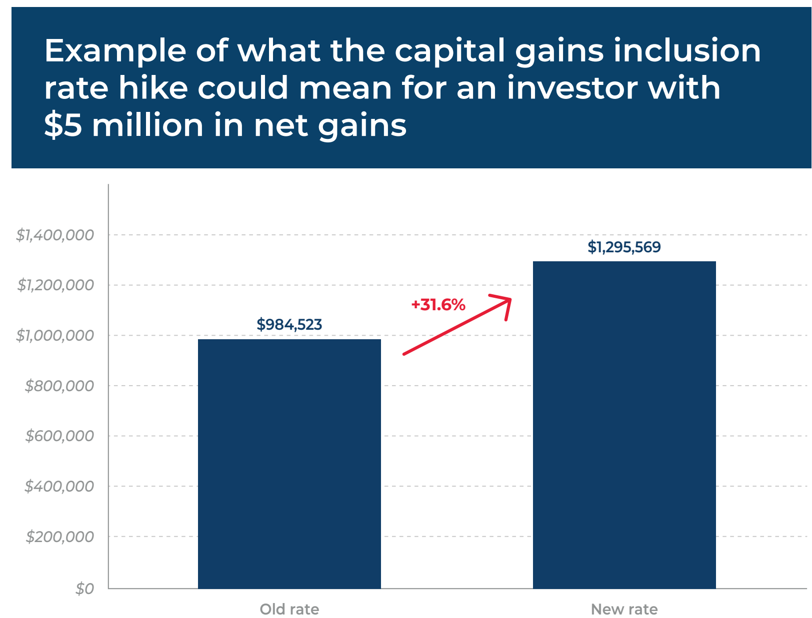
Investing in start-ups is a high-risk venture, however, as around 90% of them fail.[9] This is why a dollar made this way is not the same as a dollar made in a regular 9-to-5 job: the potential gains must compensate for the risks taken. When taxation is increased, as it has been by this change in the capital gains inclusion rate, venture capitalists still face the same amount

of risk, but with lower potential rewards. Economic logic thus predicts that venture capitalists will respond to this hike by lowering their investment in Canada.

With the increase in the inclusion rate, Quebec investors wanting to sell their shares of a business will see the effective tax rate go from 26.65% to 35.54% for gains over $250,000. This is an increase of 8.89 percentage points, or 33.34%.[10] Let's say that an investor has decided to sell her share of her first successful investment venture in 2024, after the increase in capital gains taxes is applied, and that it would bring in $5 million in net gains.[11] The taxable amount would be $3.75 million, with $250,000 taxed at the 50% inclusion rate, and $3.5 million taxed at the new 66.67% inclusion rate. The investor pays an additional $311,037.20 under the new tax regime—a 31.6% increase[12] (see Figure 1).

Figure 1

Example of what the capital gains inclusion rate hike could mean for an investor with $5 million in net gains



Note: The investor takes full advantage of the Lifetime Capital Gains Exemption.
Source: Author's calculations. Government of Canada, *Budget 2024: Fairness for Every Generation*, April 16, 2024, p. 336.

This example clearly shows why investors are less likely to invest in, and provide guidance to, start-ups at this higher inclusion rate, which will tend to lead to less innovation and entrepreneurship, both of which are essential to economic growth.

A secondary effect of increasing capital gains taxes is the potential delaying of sales by venture investors of exiting start-ups that have grown successfully (or alternatively, that are failing and wasting scarce resources) because the sale would be fiscally disadvantageous, which is called the (investment) lock-in effect.[13] If venture capitalists delay the sale of their share of a business, it means they are also delaying investing in other, newer start-ups in need of capital. Increasing the capital gains tax will thus lead to a less fluid venture capital market, and again, eventually to less innovation and entrepreneurship, and less economic growth.

Recent empirical evidence confirms these negative impacts. A 2022 peer-reviewed study found that an increase in capital gains taxation caused a reduction in investment and US-based venture-capital-backed start-up innovations, as shown through a smaller number and lower quality of patents.[14] Because investors reduce their involvement in start-ups, entrepreneurs' chances of success are also reduced, thereby decreasing the potential return on investments for both entrepreneurs and investors. This can also negatively impact the size of the portfolio of venture capital firms and their level of investment in start-ups, with a higher number of start-up write-offs.

CONCLUSION

Canada is already struggling to attract investment, and spends billions of dollars in subsidies to encourage select players such as electric vehicle battery manufacturers to invest in this country. A better approach would be to leave more money in the pockets of investors and entrepreneurs, whose innovations are a key to increased productivity and economic growth.[15]

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6. Author’s calculations. *Idem*.
7. Lora Dimitrova and Sapnoti K. Eswar, “Capital Gains Tax, Venture Capital, and Innovation in Start-Ups,” *Review of Finance*, Vol. 27, No. 4, July 2023, p. 1472.
8. Canadian Venture Capital & Private Equity Association, *2023 Canadian Venture Capital Market Overview*, CVCA Intelligence, 2023, p. 10.
9. Nicole Blair, “Startup Statistics in Canada,” Made in CA, March 12, 2024.
10. Author’s calculations, using Quebec’s top marginal tax rate (53.31%) for 2023 and 2024. TaxTips.ca, Quebec 2024 and 2023 Tax Rates & Tax Brackets, January 23, 2024.
11. This example looks at a single venture capitalist or angel investor, as incorporated venture capital firms would be subject to the higher inclusion corporate rates. The Lifetime Capital Gains Exemption (LCGE) is a measure that is a cumulative lifetime tax exemption for capital gains (made from the sale of a small business). It was raised from $1,016,836 to $1,250,000 in the 2024 budget. This amount will be indexed to inflation every year. Government of Canada, *op. cit*., endnote 1.
12. Author’s calculations.
13. As discussed in Lora Dimitrova and Sapnoti K. Eswar, *op. cit*., endnote 7, p. 1474. In addition, Budget 2024 introduces the Canadian Entrepreneurs’ Incentive, which reduces the inclusion rate to 33.3% for a lifetime maximum of $2 million. It will be implemented in increments, starting at $200,000 in January 2025, until it reaches the maximum in 2034. This measure has the potential to further increase the risk of investment lock-in. Government of Canada, *op. cit*., endnote 1, p. 340.
14. Lora Dimitrova and Sapnoti K. Eswar, *op. cit*., endnote 7, p. 1473.
15. Ian McGugan, “If pension funds can’t see the case for investing in Canada, why should you?” *The Globe and Mail*, April 19, 2024; Office of the Parliamentary Budget Officer, “PBO estimates government support for EV battery manufacturing to cost $43.6 billion,” News release, November 17, 2023.

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