NEUBERGER BERMAN

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Addressing the Challenge of Higher Capital Gains Inclusion Rates

The Liberal Party of Canada recently presented the 2024 Federal Budget, which calls for a higher inclusion rate on capital gains above $250,000 for individuals, and on all capital gains for corporations and trusts, starting June 25, 2024. We believe these changes highlight the urgency of taking a more tax-efficient approach within investment portfolios—because after all, it's what you *take home* that counts.

In this paper, we argue that better after-tax returns could be hiding in plain sight for taxable investors able to systematically harvest capital losses and defer capital gains within separately managed accounts (SMAs). While no two clients have identical tax profiles, we find that systematic tax management within custom SMAs—already a canny approach, in our view—could further boost Canadian investors' after-tax returns in the proposed inclusion rate regime.

Budget With a Bite

In mid-April, 2024, the Liberal Party of Canada presented the country's Federal Budget, which calls for a higher inclusion rate on capital gains.

In this new regime, realized capital gains would be included in income at a rate of 67% versus the current rate of 50%—effectively raising the top marginal capital gains rate for Ontario residents to 35.7% from 26.8%. The new inclusion rate would apply to corporations and trusts; individuals would get relief on net gains up to $250,000, but above that, the new rate would kick in. If enacted, the budget would go into effect on June 25, 2024. We believe this makes an even more urgent case for more tax-efficient investing.

Consider a hypothetical corporation which makes a $1 million investment that compounds at 10% for 30 years. As shown in scenario A in figure 1, that investment—if utterly untaxed—would grow to more than $17.5 million.

Now imagine the money was invested tax-efficiently—meaning that capital gains aren't realized until the end of the 30-year investment period (scenario B). Using a 50% inclusion rate, that investment would grow to $13 million; using 67%, it would only reach $11.6 million.

FIGURE 1: GAUGING THE PORTFOLIO IMPACT IF THE INCLUSION RATE RISES TO 67% FROM 50%

Scenario	Assets after 30 years assuming a 50% inclusion rate	Assets after 30 years, assuming a 67% inclusion rate
A) Untaxed	17,449,402	17,449,402
B) Tax-efficient Investment	13,046,720	11,579,159
C) Tax-inefficient Investment	8,333,833	6,487,615

Note: Assuming an implied top Ontario marginal tax rate of 53.53%.

But the picture darkens considerably assuming capital gains are realized at the end of each year (scenario C), which could be the case with a high-turnover investment strategy. At a 50% inclusion rate, the money would grow to $8.3 million after 30 years; at 67%, it would be just shy of $6.5 million.

As shown in this example, ignoring higher inclusion rates could put investors at risk of substantial tax drag. That drag comes directly from taxes paid, and indirectly from the foregone chance to compound returns on funds remitted to the CRA. The tax-efficient investor (Scenario B) in a 67% inclusion rate regime ends up with nearly 1.8 times more assets than the tax-inefficient investor (Scenario C).

A More Systematic Approach

Now consider a custom SMA that mimics an actively managed "target" investment strategy. The SMA accomplishes this by holding a subset of the target's holdings while minimizing tracking error between the SMA and the target—thereby maintaining a similar, predetermined level of risk.

We believe investors can maximize after-tax returns in the SMA by systematically trimming losing positions to offset capital gains; the cash raised from these harvesting trades can then be used to purchase other similar securities within the target strategy. The objective: *Identify an optimal portfolio that maximizes expected after-tax return while minimizing tracking error between the SMA and the target.*

To achieve this, Neuberger Berman employs optimization techniques that incorporate an investor's specific risk preferences along with other constraints, such as sector exposures and single-name tilts. Using a systematic approach, we strive to harvest losses on a frequent basis to maximize after-tax returns.

Historically, harvesting could be a particularly valuable approach for investors who can carry *losses back* to recoup capital gains taxes paid over the previous three years. Going forward in a higher inclusion rate environment, the optimal balance between carrying losses back or carrying them forward will depend on the investor's expected timing of future capital gains and legislative details yet to be released.

We use the term "tax alpha" to estimate the extra after-tax return potentially derived from disciplined tax management. In practice, our eight years of experience managing tax-optimized accounts has led us to generate 100 – 150 bps of annualized tax alpha for Canadians subject to an inclusion rate of 50%. *Under the more stringent 67% rate, we believe systematic tax management could be 32% more valuable*.[1]

What Should Investors Do Right Now?

While acknowledging that every individual's tax situation is unique, we generally believe long-term investors can benefit from tax deferral and compounding. This suggests to us that accelerating gains to increase an investor's cost basis prior to June 25 could ultimately prove counterproductive.

For example, consider an investor who has a $1 million portfolio, with a cost basis of $700,000 and is subject to the higher 67% inclusion rate. Assuming the portfolio grows at 8% a year over the following decade, figure 2 shows that accelerating gains in the current, lower-rate environment ultimately proves a worse strategy than letting those gains compound over the entire period.

FIGURE 2: ALLOWING CAPITAL GAINS TO COMPOUND MAKE MORE SENSE THAN REALIZING THEM TO AVOID HIGHER INCLUSION RATES

	Realize Gains in Lower Rate Environment	No Gain Acceleration
Potentially Accelerate Gain Realization		
Tax Cost (at a 50% inclusion rate)	**($80,295)**	$0
Market Value After Paying Taxes	$919,705	$1,000,000
Cost Basis After Paying Taxes	$919,705	$700,000
Invest for 10 Years at 8%		
Final Market Value	$1,985,574	$2,158,925
Final Tax Cost (at 67% inclusion rate)	**($376,569)**	**($515,435)**
Liquidation Value	$1,609,005	$1,643,490
Excess Value of Acceleration	**($34,485)**	

On the other hand, some investors may feel the need to make adjustments and realize capital gains in the near future simply because they aren't happy with their current portfolio. In this case, we recommend investors realize their gains—using a systematic approach—before the June 25 deadline.

Conclusion

In our view, the Canadian government's proposed changes highlight the urgency of taking a more tax-efficient approach within investment portfolios.

Specifically, we believe investors can potentially maximize after-tax returns within a SMA by systematically trimming losing positions to offset capital gains while incorporating an investor's specific risk preferences and other strategic constraints. Under the government's more stringent 67% inclusion rate, we believe systematic tax management has the potential to generate even more attractive annual tax alpha.

[1]Under the new inclusion rate regime, the effective capital gain rate could rise by [(35.3/26.7) – 1] = 32%.

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