October 9, 2020

Mr. Anthony Kong
KONG Global Executive Tax Inc.
5 Longbridge Road
Thornhill Ontario L4J 1L4

Dear Tony,

<u>Re: Capital Gains Inclusion Rates</u>

You mentioned that there are rumors about Canada potentially increasing the capital gains inclusion rate and asked for my thoughts. Subject to the disclaimer at the bottom (we will leave the tax advice to you), here is my take from an investment perspective.

It is very difficult to predict what politicians will do, especially in a minority government like the one that currently exists in Canada. That said, if a client has a high degree of confidence that it will happen (a view that I do not share), they may be tempted to trigger gains and lock in the lower capital gain inclusion rate.

As you know, Canadians are permitted to sell a stock, crystallize a capital gain, and immediately repurchase the stock (losses are different). They risk being wrong and may end up accelerating a tax payment that they might not otherwise incur and also incur trading commissions. If they have realized capital losses available to offset those triggered gains, then that strategy might make sense for certain individuals.

<u>I think that there is a better way to approach this</u>. Instead of trying to read the tea leaves to determine what the current and future governments will do with the inclusion rate, we try and take advantage of the fact that capital gains are only triggered once realized.

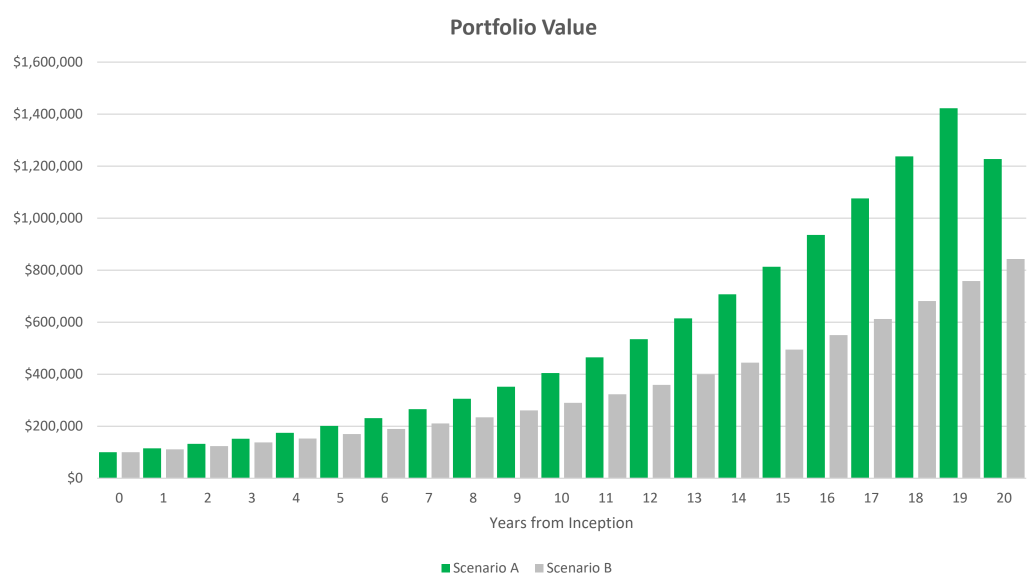
Unrealized capital gains essentially embed an interest-free loan from the government until you sell a stock or have a deemed disposition (e.g. on death without available offsets or rollovers). We try and take advantage of this free loan by investing in companies that are growing and tend to compound their value at attractive rates over long periods of time (e.g. businesses with tailwinds). Using this approach, the tax bill rarely comes due and the effect of the interest-free loan is to deliver superior after-tax returns to clients in taxable accounts.

The way that the math works, you will actually end up way ahead by deferring the gain. In Berkshire Hathaway's 1989 shareholder letter, Warren Buffett gave a concrete example which is illustrative and I have modified it slightly to take into account Canada's regime.

Assume that you start with a $100,000 portfolio and are able to grow your investments at 15% a year (pre-tax) for 20 years. I have also assumed a 50% marginal tax rate and a 50% capital gains inclusion rate so capital gains are effectively taxed at a 25% rate.

In Scenario A, you compound in the same investments and only realize the gains in year 20. In Scenario B, you sell your investments at the end of each year, pay the tax, and reinvest the net proceeds in other investments that earn the same 15% yearly and repeat the process. The result may surprise you:

	A	B
Starting Amount	$100,000	$100,000
Tax Paid	$409,163	$247,779
Ending Amount	$1,227,490	$843,336



In Scenario A, you end up paying much more tax ($409,163) but still end up much farther ahead financially ($1,227,490 million after-tax vs. $843,336).

To my thinking, maximizing the value of the tax deferral and embedded interest-free loan is what investors should focus on. Trying to predict the political winds is a mug's game and one that we largely ignore given our approach.

I hope this is helpful.

Best regards,

Michael McCloskey
Founder & President

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