FAQ: CAPITAL GAINS TAXATION[1]

Reform of the personal income tax (PIT) in Ukraine is currently being debated, with proposed legislation pending before the Verkhovna Rada. One of the issues being addressed by this reform process is that the taxation of capital gains – income derived from the increasing value of capital assets. Capital gains are taxed either as income or by a separate tax on capital gains in the vast majority of Western economies. Still, there are many areas of confusion and debate with respect to this topic. This note will attempt to answer some of the question most frequently asked by taxpayers.

1. What are capital gains?

A *capital gain* is appreciation in the value on an asset. For taxation purposes, it is generally defined as net proceeds from sale of an asset, or the profit from the sale of an investment or property.

2. What types of assets can generate capital gains?

Any asset regarded as having value in meeting debts, commitments, etc., can realize capital gains. Capital gains can be generated either by personal or business assets. Different countries identify different sources of capital gains differently. For example, the personal income tax (PIT) of Poland defines the following types of property as assets capable of generating capital gains: immovable property, property rights, movables, and securities. The PIT of France distinguishes between capital gains from business assets, securities, and immovable property. Current Ukrainian legislation contains provisions taxing income derived from some corporate rights and securities trade.

3. How are capital gains calculated?

In the simplest case, the capital gain received from the sale of the asset is the sale price net of the purchase price[2]. For tax purposes, the capital gain is usually not accrued until the time when the asset is sold. *Example:* Suppose you buy a property for UAH 1 million, and sell it for UAH 1.5 million. The capital gain would be UAH 500,000 at the time of the sale.

The calculation of capital gains can be much more complicated, however. The value of the asset can be adjusted to counteract market fluctuations, indexed for inflation, or revalued to adjust for depreciation. Different countries address these various adjustments differently[3] (many countries make no adjustments). Further, in some cases unrealized capital gain are taxed to minimize tax avoidance behavior. For example, unrealized income taxation is applied in France[4] and there are provisions in

---

[1] By Natalia Leschenko.

[2] Immovable property should be treated specially under Ukrainian draft PIT law. Namely, the sales revenue rather than net sales proceeds should be taxed in case sold immovable property belonged to a taxpayer before the new law comes into effect.

[3] Although, Ukrainian draft law levies PIT on sales revenues derived from the sale of immovable property rather than net sales proceeds, it envisages a tax privilege for income derived from primary place of residence that increases with the number of tenants that lived in this dwelling for some time.

[4] Normally, the gains are taxed only when realized. However, a holder of a substantial participation (see above) in a French or foreign company who was a resident of France for 6 years or more during the preceding 10 years and moves his residence abroad is deemed to have realized the latent capital gains on the participation at the time of emigration. The gain is determined by reference to the value of the participation at the time of emigration. A deferral is available, however, subject to the giving of an adequate security or guarantee. Equally, capital gains benefiting from a deferral or roll-over measure become, except in a few circumstances, immediately taxable on emigration

Ukrainian draft law[5] on unrealized income taxation in cases the taxpayer quits his residence in the country.

4. Are capital gains income?

Yes. Capital gains are generally considered income for income tax purposes. The Haig-Simons definition of income states: "Income is the money value of the net increase to an individual's power to consume during a period. This is equal to the amount actually consumed during the period plus net addition to wealth".[6] Net proceeds from the sale of an asset must be included into income, as it represents an increase in the potential consumption of one taxpayer in comparison to others.

5. Are gains on personal assets the same as gains on business assets?

Yes. Income is income. Capital gains on business assets represent income to the business, and should be taxed as income to the enterprise. Capital gains on personal assets represent income to the individual, and should be taxed as income to the physical person.

6. Is taxing capital gains fair?

Yes. Said the other way, the failure to tax capital gains would be unfair. One of the basic tenets of public finance is the principle of *horizontal equity*, which states that persons of equal resources should pay equal tax. As capital gains represent income, failure to tax capital gains would put a person who earns income from labor at an unfair disadvantage to a person who earns an equal amount of income from capital gains.

7. What about capital losses? Should I be allowed to deduct those?

Yes. The ability to use capital losses (negative capital gains) to offset other income should be a basic tenet of any attempt to tax capital gains. Just as losses in one aspect of business operations can be used to balance profits in another endeavor, current capital losses should be used offset current income. Further, just as losses in business are allowed to be *carried forward* to offset future income (and in some cases *carried back* to offset past income), capital losses should be allocated dynamically as well.

International experience does not, however, provide a clear application of this principle. Many countries restrict the utilization of capital losses to smooth the revenue stream received by the Budget or simply to simplify the determination of liability. For example Poland allows losses to be carried forward for 5 years. However, an upper limit for losses is established, restricting the utilization of a capital loss at 50% of the value of the loss each year. Loss carry-backs are not allowed. At the same time, the legislation of France clearly states that capital losses from the disposal of immovable property may not be set off against any income category. However, the calculation procedure for immovable property that was held for more than 2 years are eligible for privileged tax treatment. Ukrainian draft law does not allow carry-forwards, however, capital losses from the disposal (or exchange) of investment assets can be set off against investment income category during current taxable year.

[5] Draft PIT law, 1st reading: [12.7.2] the house/apartment purchased from the funds of the housing mortgage shall be regarded for purposes of taxation as sold at a fair market price and such tax payer shall be deprived of the right to increase the amount of tax credit as from the year when such departure/change of citizenship takes place;

[6] **Harvey S. Rosen.** *Public Finance.* 4th ed. Irwin: McGraw-Hill, 1995, p.360.

8. Does taxing capital gains mean that inflation will increase my tax burden?

Yes and no. Just as in all income and many consumption-base taxes, when prices go up, nominal tax liability also increases. If this is the result of general inflationary tendencies, then there may be no real change in liability, as the higher amounts are paid for with depreciated currency.[7] In reality, real liability is likely to increase during inflationary periods, as a result of the *inflation tax*.

Example. Consider economy with real assets of 100 tons of corn. Suppose that there are UAH 100 in circulation, and that the velocity of money is one. The resulting price for a ton of corn would be UAH 1, and anyone with UAH 1 could by a ton of corn. Now suppose that the government (central bank) prints an additional UAH 100. If nothing else changes, there will be UAH 2 for every ton of corn, and so the price of corn will increase to 2 per ton. The government possesses the extra UAH 100, and as a result, is able to purchase 50 tons of corn, leaving only 50 tons for the general population. Thus, the increase in the price of corn has acted as a tax, shifting real wealth equal to 50 tons of corn to the government.

In terms of the capital gains tax, inflation is a mechanism by which the wealth is transferred to the government during periods of inflation.

Example. Suppose a taxpayer purchases an asset for UAH 100. If the value of that asset does not change in the future, and the taxpayer sells the asset for UAH 100, there will be no gain, and no tax. However, if there is inflation, and the price of the asset increases to UAH 110 in nominal currency, the taxpayer will realize a capital gain of 10, and will see a tax liability on that gain, where there was no gain in the absence of inflation.

It is important to reiterate that the problem with inflation is not unique to the taxation of capital gains. During inflationary periods, the tax-like effect of inflation influence wages, profits, and other types of income.

If the gain is the result of a market fluctuation, meaning that some prices are going up and others are going down, then there can be some real reallocation of tax liability amongst taxpayers. Taxpayers seeing a capital gain will see an increase in tax liability, while those realizing capital losses will see a decrease in liability. The end result would be no net change in aggregate tax liability.

9. Does taxing capital gains result in the double taxation of investment income?

No. It is commonly argued that taxing capital gains results in the double taxation of investment income. The argument is that the value of an asset is determined by the expected flow of earnings from the asset, with those earning (such as dividends) already subject to taxation as income. Any increase in the value of the asset would represent an increase in expected earning, and as such, those earnings would be taxed when they are realized. This type of double taxation is possible, but only if the taxation of capital gains is poorly defined.

Example: Assume persons *A* and *B* live in a simplified world where the interest rate is 0%, inflation rate is 0%, the income tax rate is 50%, and transaction costs are 0. As one can see from Table 1, Block 1 (*Income, Costs, and Taxes w/o Sale of Asset*), in year 0, person *A* buys a security for UAH 1,000, that would bring UAH 200 in returns during years 1-5, with a redemption value to be repaid in year 5 of UAH 1,000. Tax liability in periods 1 through 5 is UAH 100 per period, and there are no capital gains accrued on the sale at the end of period 5. Total tax liability is UAH 500.

[7] If the income tax has graduated income brackets, real increases are possible as taxpayers creep into higher tax brackets.

Table 1: Capital Gains with Offsetting Capital Losses

Block 1: Income, Costs, and Taxes w/o Sale of Asset

	Person A				Person B			
	Income	Costs	Net Income	Tax	Income	Costs	Net Income	Tax
Activity in year 1	200		200	100	-		-	-
Activity in year 2	200		200	100	-		-	-
Activity in year 3	200		200	100	-		-	-
Activity in year 4	200		200	100	-		-	-
Activity in year 5	200		200	100	-		-	-
Capital gain/loss	1 000	1 000	-	-	-	-	-	-
Total	**2 000**	**1 000**	**1 000**	**500**	**-**	**-**	**-**	**-**

Block 2: Income, Costs, and Taxes w/ Sale of Asset at the end of Period 2 w/ Gains and Losses

	Person A				Person B			
	Income	Costs	Net Income	Tax	Income	Costs	Net Income	Tax
Activity in year 1	200		200	100	-		-	-
Activity in year 2	200		200	100	-		-	-
Activity in year 3	-		-	-	200		200	100
Activity in year 4	-		-	-	200		200	100
Activity in year 5	-		-	-	200		200	100
Capital gain/loss	1 300	1 000	300	150	1 000	1 300	(300)	(150)
Total	**1 700**	**1 000**	**700**	**350**	**1 600**	**1 300**	**300**	**150**

Block 3: Income, Costs, and Taxes w/ Sale of Asset at the end of Period 2, w/ Increased Return

	Person A				Person B			
	Income	Costs	Net Income	Tax	Income	Costs	Net Income	Tax
Activity in year 1	200		200	100	-		-	-
Activity in year 2	200		200	100	-		-	-
Activity in year 3	-		-	-	220		220	110
Activity in year 4	-		-	-	220		220	110
Activity in year 5	-		-	-	220		220	110
Capital gain/loss	1 330	1 000	330	165	1 000	1 330	(330)	(165)
Total	**1 730**	**1 000**	**730**	**365**	**1 660**	**1 330**	**330**	**165**

Next, assume that *A* sells the asset to *B* at the end of period 2 (see Block 2, *Income, Costs, and Taxes w/ Sale of Asset at the end of Period 2 w/ Gains and Losses*) for UAH 1,300.[8] *A* will receive income from the asset in periods 1 and 2, and then realize a capital gain of UAH 300 in period 3. Hence, at the end of period 2, his sales income is UAH 1,300. *B* will receive income from the asset in periods 3 through 5, and then sell the asset for a capital loss of UAH 300 at the end of period 5. In other words, person B receives sales income in the amount of UAH 1000 at the end of period 5. Total tax liability (adding *A* and *B* together) remains at 500, the same as if the asset had never been sold. Please note that this is only true if *B* is allowed to reduce her taxable income by the amount of the capital loss at the end of period 5.

Finally, assume that due to some innovation, the stream of earnings increases by UAH 20 for years 3-5 (see Block 3, *Income, Costs, and Taxes w/ Sale of Asset at the end of Period 2, w/ Increased Return*). Person *A* decides to realize his gain and sell the security for UAH 1,330 to person *B* at the end of year 2, resulting in an *additional* capital gain of UAH 30. Therefore, person A receives UAH 1330 of sales income at the end of year 2. The capital gain for taxable purposes of person *A* is 330, thus, his capital gains tax is UAH 165. During years (year 3-5), *B* would earn UAH 220 of before-tax income (equivalently, UAH 110 of after-tax income). At the end of year 5, person *B* would receive redemption value of UAH 1,000. This implies that his sales income is UAH 1000 appears at the end of the year 5. Hence the capital gain amount for taxable purposes would be UAH –330 (or a capital loss of UAH 330). Total tax liability (adding *A* and *B* together) increases to 530, which accurately reflects the increase in taxable income of UAH 60 (three periods of additional 20). Once again, if

[8] The sale price is open to negotiation. *A* will not likely sell the asset for less than UAH 1,000. *B* will certainly not pay more than UAH 1,600. UAH 1,300 was chosen for purposes of discussion.

person *B* is able to utilize this capital loss to offset other income, or to carry the loss forward or back to offset income in another period, all income will be taxed and taxed only once.

10. Does taxing capital gains provide any risks to the Budget?

Yes. Since capital gains are driven by changes in the sale price of assets, taxes derived from capital gains can be quite susceptible to dramatic market fluctuations as are often seen in organized stock markets. The Budget can be especially at risk during period of extreme price reductions, which will generate a large flow of capital losses. If the Budget is required to reduce its tax base by the amount of realized capital losses, there can be significant reductions in the government's ability to fund the Budget. For this reason, it is not uncommon for countries to impose limitations of the deductibility of capital losses either by capping total capital losses, limiting losses to only offsetting capital gains, or spreading them over several tax periods. To compensate taxpayers for reduced risk to the Budget, many countries tax capital gains at a reduced rate.

French legislation says that capital gains on business assets and securities may be either taxed separately at a reduced flat rate or added to taxable income. Austria and Poland have similar provisions. The UK has established a separate capital gain tax. Greece sets a withholding tax for only certain types of capital gains. The Ukrainian draft law as well as current legislation states that investment income accounting should be conducted separately on annual basis.

11. Does taxing capital gains inhibit economic growth?

Yes. By reducing the after-tax return on a capital investment, a capital gains tax could reduce the tendency of members of the economy to invest. However, this is no different than taxing dividends or interest on bank accounts.[9] The economic growth objectives of the country should be weighed against the criteria of fairness, which requires that *all* income (including investment income) be taxed. Otherwise negative issues like tax avoidance and inefficient allocation of resources could arise.

12. Should capital gains on immoveable property be taxed?

Yes. Once again, a capital gain is realized when an asset is sold for more than the owner has invested in it. In the case of immoveable property, that means selling an asset for more than it's book value (after depreciation net of capital improvements). If adjustments for depreciation were not made, an enterprise could fully depreciate an asset, sell it for a nominal amount, and then claim the entire purchase price as a capital loss, which would be inappropriate.

13. Should capital gains on my place of primary residence be taxed?

Yes. An asset is an asset. The difficulty in imposing capital gains on personal residences is that these assets are not generally depreciated, making it difficult to accurately calculate the asset's value. One solution to this problem is to simply calculate the capital gain from the original purchase price, and disallow capital losses. This approach effectively underestimates any capital gain, but keeps taxpayers from claiming inappropriate capital losses.

To promote the development of owner-occupied housing, many countries *roll-over* realized capital gains as long as those gains are used to purchase new residential housing for primary residence. In this way, capital gains derived from the sale of a primary residence can be used by the taxpayer to purchase additional housing on a tax-deferred basis.

[9] An exception to this analogy is the *lock-in effect* some have identified with a capital gains tax. Since tax liability is only accrued upon realization, there is a disincentive for investors to change portfolios. This leads to investors to hold a sub-optimal portfolio, resulting in an additional market distortion.