The B.C. School Tax: *The Thin Edge of the Wedge*

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> "Property taxes in Vancouver, specifically, are already the highest in the country and that is before this new tax comes into effect"

When you look up the phrase "thin edge of the wedge" in the online Cambridge Dictionary it simply says this:

"The beginning of harmful development"

That would be a great place to start a newsletter on the new School Tax that was introduced in the last provincial budget. Most of our readers are already aware of the details, but a short summary is below:

- The School Tax is a percentage based tax on B.C. homeowners whose annual assessment of the value of their home exceeds $3 million at 0.2% annually up to $4 million and then 0.4% on any amount above that.
- If one owns a home worth $6 million then the additional tax will be $10,000 per year.
- This new tax plus the additional "speculation tax" on B.C. homes (primarily recreational properties) is expected to increase provincial revenue from property tax over three years by about 35%. At the same time the provincial economy (which has to fund all taxes) is expected to grow by about 12% over the same three years in nominal terms. The tax increase is about three times the rate of growth of the province overall.

Proponents of this tax make their case for it being reasonable and fair based on the following:

- This tax only impacts wealthy families who own homes worth more than $3 million.
- In most cases these homes have seen their assessed value increase by almost 400% since 2007 and for most homeowners that is a tax-free capital gain when the home is sold.
- People over the age of 55 can defer taxes at very low interest rates if they cannot afford to pay the tax on a current basis *(presumably those under 55 can do what Marie Antoinette suggested and eat cake)*.

In most developed countries there are three fundamental types of taxes:

- Taxes on income for individuals and companies. Typically these taxes are progressive for companies and individuals *(more progressive for individuals)* and peak out at about 50% in Canada.
- Taxes on consumption *(both services and goods)* including sales taxes, tariffs, royalties, etc.
- Taxes on capital such as property taxes and sometimes the capital of large corporations.

It is my own opinion that capital gains taxes are not a tax on capital; they are a tax on the profits earned when an asset has been sold and so the gain is really just another form of income. The key issue here is that no tax is due until a profit on the asset is realized as a result of the sale of the asset. One exception to this is the capital gains tax payable by estates when someone dies, and any unrealized gains on assets owned by the deceased are then subject to capital gains tax, even though the assets have not been sold.

It should be noted that capital gains taxes apply to all assets except one's personal residence.

The new School Tax is specifically a tax on one type of asset and in many cases does not represent any objective tax based on the wealth of the individual or couple who own that home. Many of our readers are outraged by a tax that the government purports to be a reasonable tax on wealth, but that is arbitrary and unaccountable in terms of where the revenue is going *(it goes into general revenues and not specifically for schools)* and in terms of insuring that a progressive tax such as this is being borne by those most able to pay.

Below we outline all of our own observations for why this tax is a poor way to raise revenue for the government.

- The last provincial budget estimates are that the School Tax will generate about $200 million in revenue within three years. At that time, the annual provincial budget is expected to be $58 billion. This tax is expected to be about 1/3 of 1% of revenue and will make little difference in the services the government wants to offer.
- *"Property taxes in Vancouver, specifically, are already the highest in the country and that is before this new tax comes into effect"* as **Elizabeth Murphy pointed out recently in the Vancouver Sun (Figure 1).**
- This tax is only on residential homes. It does not apply to commercial, industrial, retail, or multi-family residential real estate. To use an example, Fred and Margaret own a home worth $6 million and will have to pay $10,000 more in property tax. In their case, the tax is not deductible so it must come out of their after-tax income. If their tax rate is 50% at the margin, then they need $20,000 of pre-tax income to first pay $10,000 in income taxes *(1/3 of that would go to the B.C. government)* and then another $10,000 in new property taxes.

  Bob owns a home worth $2.5 million, but also owns a small apartment building worth $20 million. He has far more wealth and real estate than Fred and Margaret, but he will pay no additional tax. If he had to pay an additional $10,000 of tax on his apartment building that would have been tax deductible to him and cost him half as much as it would Fred and Margaret.
- This tax applies regardless of the actual equity that someone has in their home. Earl and May rebuilt their $3 million home and spent $2 million to do it. The home is now assessed at $5 million and they have a $3 million mortgage. They will now pay $6000 per year in additional tax even though the equity they have in their home is $2 million. Meanwhile, their neighbour's house is worth $3 million, and since they have no mortgage they have more equity in their home than Earl and May and they will pay no additional tax.

- Capital taxes are often regressive and unfair since they are taxing capital before there is a realized profit that has been converted to cash. Is it the intention of the government to rebate taxes to those whose property values fall? This question is very relevant today given how soft the residential market is *(especially above $3 million)*.
- Property taxes are the main source of revenue for municipalities. When the provincial government comes in and taxes property in this way, they are reducing the ability of each municipality to provide needed local services from their main source of revenue.

In a discussion I had with David Eby, I asked him if the main purpose of this tax was to raise revenue from those who had accumulated wealth above a certain level. As you might appreciate, I never received a direct response to the question, but there was no doubt that the government is making an assumption that those who will pay this tax can afford to. What I then asked David to respond to, were the following with respect to wealth overall and how to measure it. If one is going to tax wealth, then why choose a tax on only one type of wealth?

Why would retirement savings not be included or other types of real estate, shares of private and public businesses, savings accounts, insurance policies, etc.?

If an individual for example has $2 million in investments, a $3 million home clear title and an indexed pension that is worth $3.5 million and is currently earning $200,000, then that person has a net worth of $8.5 million. That would put them easily in the top 1% of Canadian wealth and top 1% in terms of income. Yet none of this is being used as the basis for raising $200 million in new provincial revenue.

I pointed out to Mr. Eby that his boss, John Horgan, will be entitled to a fully indexed pension plan equal to 70% of his best three years income with only 20 years of service *(teachers by comparison have to work 35 years to get the same pension levels and then it is based on best five not best three)*.

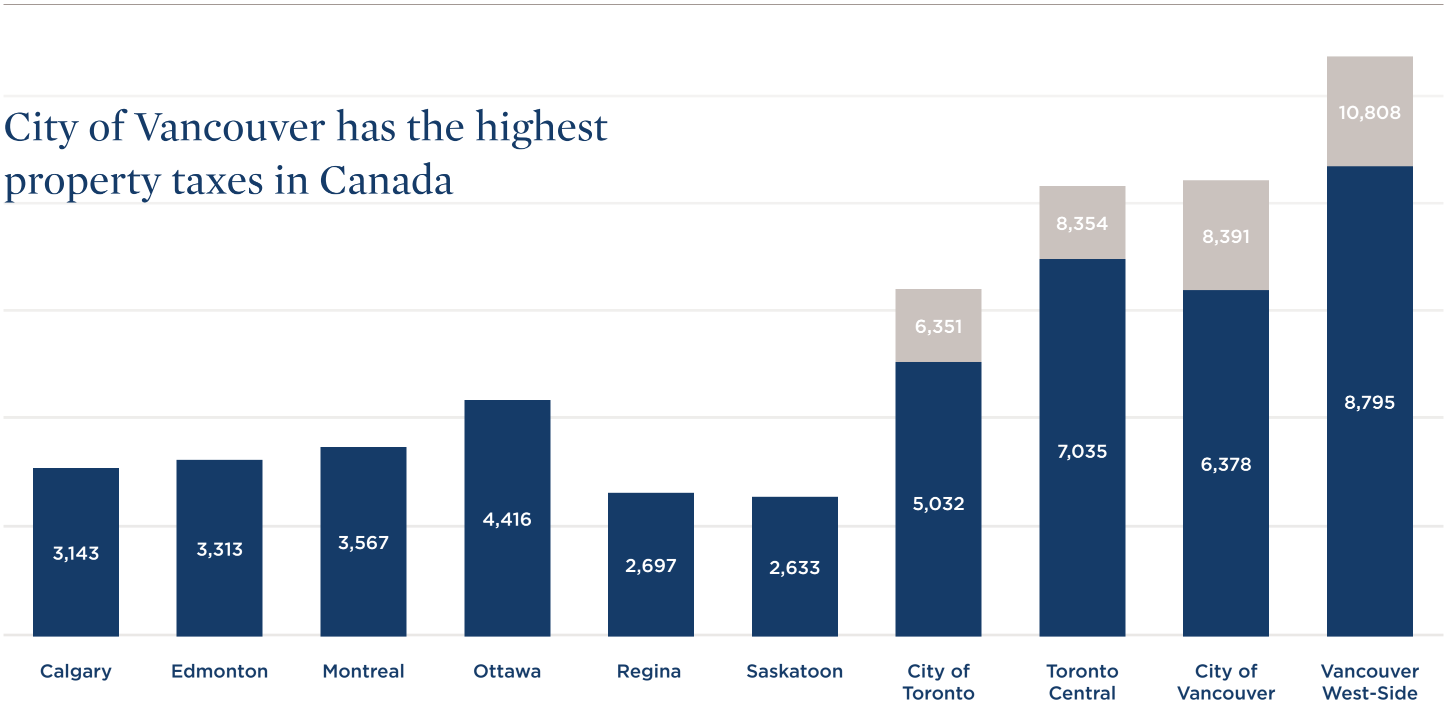
Mr. Horgan has had his income almost double because he is now Premier of the province and not just an MLA. Our estimate *(based on http://members.leg.bc.ca/mla-remuneration/employment-benefits.htm)* is that at or before age 65 he will be entitled to an indexed pension of about $140,000 per year with survivor benefits.

Figure 1

Property Taxes Paid Based on MLS Benchmark

(Adjusted for the assessment Methodology use in Toronto)

Base Tax Utilities



Source: Andrey Pavlow, Ph.D., Professor of Finance, Beedie School of Business, SFU, April 2018 (Based on most recent 2017 property tax data.)

In today's marketplace it would cost at least $3.5 million to acquire such a pension. Here are some other observations about the MLA/Premier pension benefits.

- If you were trying to build a $3.5 million dollar RRSP account over 20 years, assuming a 4% after inflation rate of return, you would need to be able to put away more than 70% of your pre-tax income to achieve this goal. In the case of an MLA or the premier, they contribute 11% of their pay to the pension, and the government funds the other 61% *(by our estimate)*. The additional contributions do not show up as a cash benefit. They do not show up on their personal tax return and it is unlikely that the cash value of the pension shows up on an MLA's net worth statement, even though their RRSPs would.

It seems to me that these pension benefits are real wealth and very tax efficient and low cost to the owner of the asset. If we are taxing wealth and the ability to pay on the basis of that wealth, then why would assets such as these be excluded?

We started this newsletter with a dictionary definition of *the thin edge of the wedge*, with respect to taxing personal homes. Dr. Paul Kershaw, tenured professor at the UBC School of Population and Public Health, believes that not just the top 2% of homes should have additional taxes, but the top 20% *(homes over $1 million)*. The tax would be 1% and raise $3 billion per year *(people would be able to defer the tax and pay it when the home is sold)*. This means that each homeowner would have a partner in the ownership of their home with the following conditions:

- No need to put up any capital.
- Able to increase share of the equity of the home over time.
- You are not guaranteed to get your capital back first. Your partner's equity comes off the top before any capital comes back to you.

And some people think the mafia has tough "partnership" terms.

Let's assume in this period of lower expected returns on most asset classes that future returns on homes just match inflation *(as has been the case in most of the world for the last 50 years)*. Let's further assume you acquire a home for $1 million today under professor Kershaw's model. Your tax is 1% annually and you can defer it. If inflation is 2% per year, then your home is $1,650,000 in 25 years. Even if the government agrees to allow you to defer the taxes with a 1% rate of interest, your deferred tax bill will be about $360,000 payable when you sell the home. That is about 22% of the entire value of your home and, more importantly, about 54% of your profit on the home.

So here you are assuming any appreciation on your home is tax-free and in this case it would cost you a tax rate that is more than double what you would have paid on an investment property. How does this type of taxation encourage saving for a home? **This is the Thin Edge of the Wedge.**

We encourage you to write and call your MLA and express your concerns. We will be collecting articles and data on this question as we did for the Tax reform, so look on our website and use anything that might be of assistance. Even if your home is worth less than $3 million and not currently impacted by the new School Tax, there are many ideologues that support any number of taxation models to increase government revenue.

As Churchill once wrote, *"trying to tax a country into prosperity is the same as a person trying to lift themselves out of a bucket by the handles."*

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WEALTH MANAGEMENT

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