



CESTNICK

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TAX MATTERS

## The impact of the ‘inflation tax’ can be huge for investors

SPECIAL TO THE GLOBE AND MAIL  
PUBLISHED JULY 15, 2021

Maybe you’ve heard the story about the guy who stopped at a gas station to fill his tires with air. It cost him \$1.50, which frustrated him, so he walked into the on-site convenience store to speak to the employee there. “Why in the world are you guys charging for air? I used to fill my tires for free. What happened?” The employee replied: “Sorry, it’s inflation.” (Groans from audience.)

There’s a lot of talk about inflation these days. The Bank of Canada commented this week that inflation is expected to remain at or above 3 per cent over the balance of this year. The consumer price index grew at an annual rate of 3.6 per cent in May and 3.4 per cent in April.

### THE PROBLEM

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In the 1970s and early 1980s, for those who remember those days, inflation hit double digits in Canada. So, history tells us that inflation can last for many years. There’s a debate about whether the inflation we’re experiencing today is going to be with us for the long term or is simply a short-term reflection of pent-up

demand and restricted supply resulting from the pandemic.

### Changing the use of a property can come with a tax surprise

### How to plan ahead for postelection tax changes

Regardless of its longevity, we would all do well to recognize an important fact: Inflation is a tax. We spend a lot of time talking about the taxes levied by our governments and what can be done to minimize the erosion of capital and income that results from the taxes we pay. Yet inflation has the same effect.

In a Fortune magazine article in 1977, Warren Buffett had this to say about inflation: “The arithmetic makes it plain that inflation is a far more devastating tax than anything that has been enacted by our legislatures. The inflation tax has a fantastic ability to simply consume capital.”

## THE EXAMPLE

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Consider the example of someone with \$1,000 to invest. Suppose she earns 5 per cent, or \$50, on her portfolio this year. Let's assume there's no inflation, but she pays taxes of 100 per cent on those earnings – I know that's not a realistic tax rate, but stay with me. So she would pay \$50 in taxes and would be left with just \$1,000 after taxes to spend on a particular basket of goods and services – let's call it Basket A.

Now, let's change the facts. Suppose that same investor earns the same 5 per cent, or \$50, but let's assume there are no taxes at all – yet annual inflation is 5 per cent. She's left with \$1,050 in her pocket. But the price of Basket A has risen to \$1,050, so she can purchase Basket A and nothing else. This leaves her in exactly the same situation as the first scenario.

As Mr. Buffett put it in 1977: “It makes no difference to a widow with her savings in a 5.0 per cent passbook account whether she pays 100 per cent income tax on her interest income during a period of zero inflation, or pays no income taxes during years of 5.0 per cent inflation. Either way, she is ‘taxed’ in a manner that leaves her no real income whatsoever.”

Here's the thing: The woman in our story would consider a 100-per-cent tax rate to be outrageous, but she may not even notice that inflation can have the same impact on her financial well-being.

## THE FUTURE

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It's no secret that our government's fiscal policy support during the pandemic has exceeded 23 per cent of GDP. At some point, the debt incurred in the process will have to be paid back. The interesting thing about inflation is that it's a double-edged sword. The debt incurred throughout the pandemic will become cheaper to retire since it remains in 2020 and 2021 dollars, while the resources to pay back the debt will be in future dollars.

But make no mistake – inflation alone won't get rid of the accumulated debt. Don't be surprised when the government looks for ways to increase taxes to eventually reduce the debt. The problem, of course, is that stacking legislated tax increases on top of the inflation tax is going to result in a double tax hit that could seriously harm the standard of living of the investor – or many Canadians – in our story. Let's hope politicians understand this and think twice when they consider changes to our tax law.

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