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TAX MATTERS

The tax of inflation impacts investors significantly

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I was talking with our oldest son, Win, about the cost of life this week. "Win, I'll admit that when your mother and I first got married, we were debating about whether to buy a three- or four-bedroom home. A young couple could afford a home back then."

"Dad, that's not the same conversation I'm having with Sarah today. We're getting married in June and we're debating whether we need a studio apartment – or whether we should settle for a closet."

"Take the closet," I said, "You'll avoid plumbing and electrical problems."

While housing affordability might be a big issue facing a lot of people, the cost of just about everything has gone up recently. Inflation makes life harder. In effect, it's an additional tax on everyone, including investors. Let me explain.

The issues

You might not think of inflation as a tax, but it is – and it affects investors significantly. Consider two brothers, Jake and Jeremy. Each brother has $10,000 to invest and can earn 3 per cent on his money (today's rate on a one-year cashable GIC at a major bank), or $300 of interest over one year. Suppose Jake lives in a world where there's no inflation, but he pays taxes of 100 per cent on his income (I know the tax rate isn't realistic, but stay with me). So, Jake would pay $300 in taxes and is left with $10,000, and can buy a basket of goods and services with the money – call this Basket X.

Jeremy, on the other hand, faces inflation of 3 per cent, but pays no taxes. His $10,000 grows to $10,300 after one year. So, he has more than Jake after taxes. But the price of Basket X has risen from $10,000 to $10,300 because of inflation, so Jeremy can purchase Basket X, and nothing else. Both Jake and Jeremy are left with the same purchasing power after taxes and inflation (they both end up with Basket X). The bottom line is inflation and taxes have the same detrimental impact on purchasing power. So, think of inflation as a tax.

What about capital gains? As Canadians, we face tax on illusory gains. Suppose you have investments worth $10,000 today and earn 6 per cent on your money – all in capital growth – over the next 20

years. At the end of that time your portfolio would be worth $32,071. But if we suppose inflation was 2.5 per cent annually over that time, your portfolio would be worth the equivalent of just $19,572 after adjusting for inflation. Yet, you'll face capital gains taxes based on the $32,071 value.

While it's true just one half of capital gains are taxable, this concession was never introduced to offset the impact of inflation. It was to encourage risk-taking to facilitate business growth, and to give investors a break because of the double-tax impact when a corporation pays taxes on its earnings (those earnings give rise to increases in share prices, which are also taxed when investors sell their shares).

Back to our example. If you were to sell your investment for $32,071, you'd realize a capital gain of $22,071 ($32,071 less your cost of $10,000) and would pay tax on 50 per cent of that gain, or $11,036. But if you weren't taxed on illusory (that is, inflationary) gains, you'd have a capital gain of $9,572 ($19,572 less your cost of $10,000). Even if you paid tax on 100 per cent of that gain, it would still be less than the taxable capital gain of $11,036 under the current rules.

The end result here is that your effective tax rate on real capital gains is quite high; call this your real tax rate. This real tax rate on capital gains increases as inflation rises. As an aside, this also has the effect of exacerbating portfolio lockup where investors won't sell their securities because of the tax implications.

The solutions

In an ideal world, our government would allow investors to index their investment cost amounts to inflation, resulting in taxes on real capital gains only. But this is unlikely.

The government, however, should take note of the inflation problem and not make matters worse by increasing taxes. Consider the capital gains inclusion rate, which is currently 50 per cent. There's been consideration given to increasing this rate, which would place an even higher real tax rate on capital gains – a sure way to stifle investment. The inclusion rate should remain unchanged.

In 2024, other tax increases are already planned: Canada Pension Plan contributions and Employment Insurance premiums are increasing (both CPP and EI combined will now cost employees $5,104 for those earning $73,200 or more). Also in store are increases to the carbon tax, alcohol taxes and the digital services tax.

These things only make the problem of an expensive life in Canada even worse.

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