Intelligence MEMOS

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To: Canada's Tax Collectors

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Re: **LET'S STOP THE ADDED INFLATION PAIN FROM CREEPING TAXES**

On the same day last week, we learned the consumer price index was up 6.9 percent year over year in October, and how much the federal government's inflation-indexed tax may raise the price of beer.

Inflation and tax rules often combine to increase Canadians' tax burdens. Governments seem readier to adjust taxes for inflation when doing so makes the burden heavier than when it makes the burden lighter.

That should change.

Adjusting some tax rules for inflation is easy. Most taxes on employment income and government benefit payments use thresholds that rise as prices do. The federal government indexes personal income tax thresholds, benefit payments and most tax credits to the CPI – for 2023, the adjustment will be 6.3 percent. But some provinces do not. Ontario does not index its top two income thresholds and Nova Scotia and PEI do not index any.

Some thresholds that would be easy to index remain unindexed. Examples include the federal government's pension income credit, the First-Time Home Buyers' Tax Credit and the maximum education and tuition credits that tax filers can transfer to spouses or parents. The threshold for the federal small business income deduction has not changed since 2009. Thirteen years later, inflation has cut its real value by a quarter. The small-supplier threshold for the GST has not changed since 1991, when GST began. After more than 30 years, inflation has cut its real value almost in half. Another egregious example is the $10,000 foreign employee exemption in the Canada-US tax treaty. After more than 40 years, inflation has cut its real value by almost three-quarters – a major hassle for people who do minimal amounts of work in Canada.

Old examples foretell the problems newer examples will create. The federal government recently imposed extra taxes on cars and aircraft costing more than $100,000 and boats costing more than $250,000. Inadequate thought about how to apply these taxes have made them a major headache for many retailers and businesses. Inflation and cost-increasing regulations on motor vehicles will push many more above the $100,000 threshold in future. Other federal examples are the $50,000 limit on passive income in a private corporation, after which the small business deduction gets clawed back, and the exemption levels under the proposed interest deductibility limits for certain corporations. Inflation without indexation will soon make those bite harder than originally intended.

Other taxes are harder to adjust but are damaging enough to warrant the effort. Take taxes on investment income. Individuals investing in tax-recognized accounts such as defined-contribution pension plans, RRSPs, TFSAs, RESPs and the newly created FHSA (First Home Savings Account) do not have to worry about inflation affecting returns inside those plans, since they are not taxed. But returns on investments outside these accounts are taxed, including the portion of the return that only serves to offset inflation's erosion of the principal. The higher the inflation, the higher the tax imposed on an illusory gain.

Capital gains taxes – even with an inclusion rate of only 50 percent, which is intended to compensate for inflation – also hit illusory gains. Inflation raises the nominal value of assets such as stocks, bonds and real estate even if that nominal gain reflects no real gain. No matter: capital gains tax hits it all. Rather than adjusting the cost base of an asset for inflation so only real returns would get taxed many advocates are pushing for a higher inclusion rate. If they get their way, Canadian savers will get hit harder.

Inflation first exceeded the Bank of Canada's 2-percent target in early 2021. This year it hit a four-decade high. Even if the Bank gets it back to 2 percent by the end of 2024, as it currently predicts, our money will still have lost about 8 percent of its purchasing power since 2021. And governments will rake in more revenue from tax increases legislators never voted for and most people didn't know were coming. The longer inflation stays high, the worse the pain will be.

Both separately and together, inflation and taxes are hurting Canadians. If governments can make beer taxes escalate with inflation, they can stop other taxes escalating with inflation. Inflation is bad enough. Taxes should not make it worse.

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