



WEEKEND READING

Shedding the light on what's happening - our world - our finances - our times

Inflation Nation

We're on a rant this week on inflation and tax policy.

'Special Report: Attract private investment: Canada's only way out' - Stephan Marion – NBF March 11, 2024

With the recent budget in mind, we're returning reader attention to Mr. Marion's report featured in our March 15 Weekend Reading. As we've repeated, and Mr. Marion confirms, increased productivity is Canada's only path to improved standards of living...for all of us, not just 'the rich'. If a new idea reduces the cost and increases the supply of potatoes, this leaves more money for protein on the plate. Policies that increase costs, reduce money available. Increased regulations, taxes and red tape suppress productivity, increase inflation, and suppress or outright contraction of standards of living, reducing income to government creating a painful feedback loop. Governments won't face down costs so crank up the tax, receive less money, drive up deficit financing adding to debt. Round it goes.

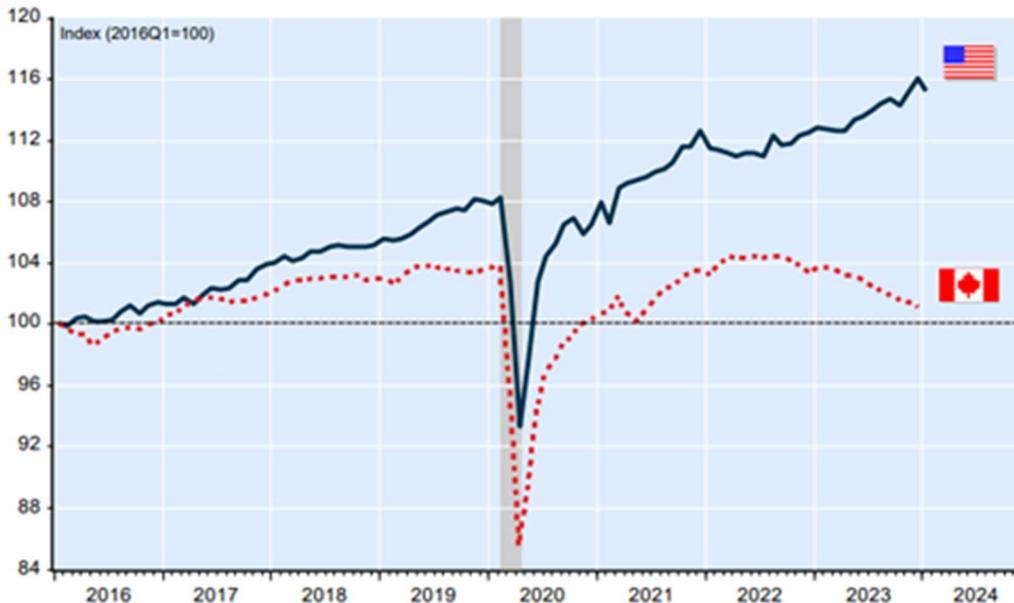
Mr. Marion's March notes.

<https://nbf.bluematrix.com/sellside/EmailDocViewer?encrypt=f67b40bb-6e40-4670-a100-911cf2ddda2a&mime=pdf&co=nbf&id=steve.hilberry@nbc.ca&source=libraryView>

Charts courtesy of Mr. Marion.

Canada: Standard of living is declining

Real GDP per capita: Canada vs. the U.S.



NBF Economics and Strategy (data via Statistics Canada and BEA)

Canada: Productivity gap with the U.S. continues to widen

Ratio of Canada to U.S. business sector productivity

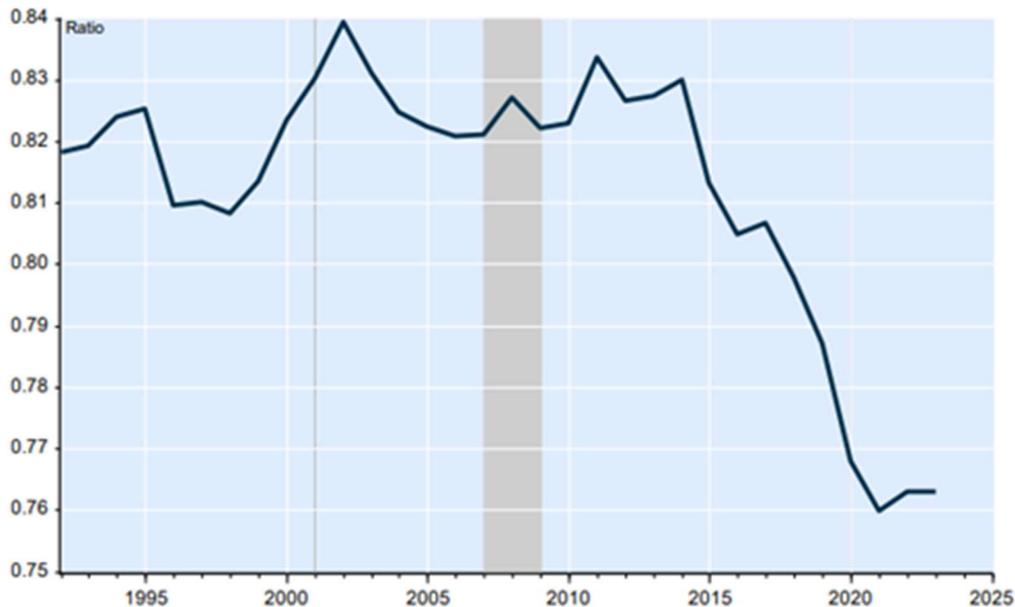


NBF Economics and Strategy (data via Statistics Canada and Refinitiv)



Canada: Down to 76% of U.S. level

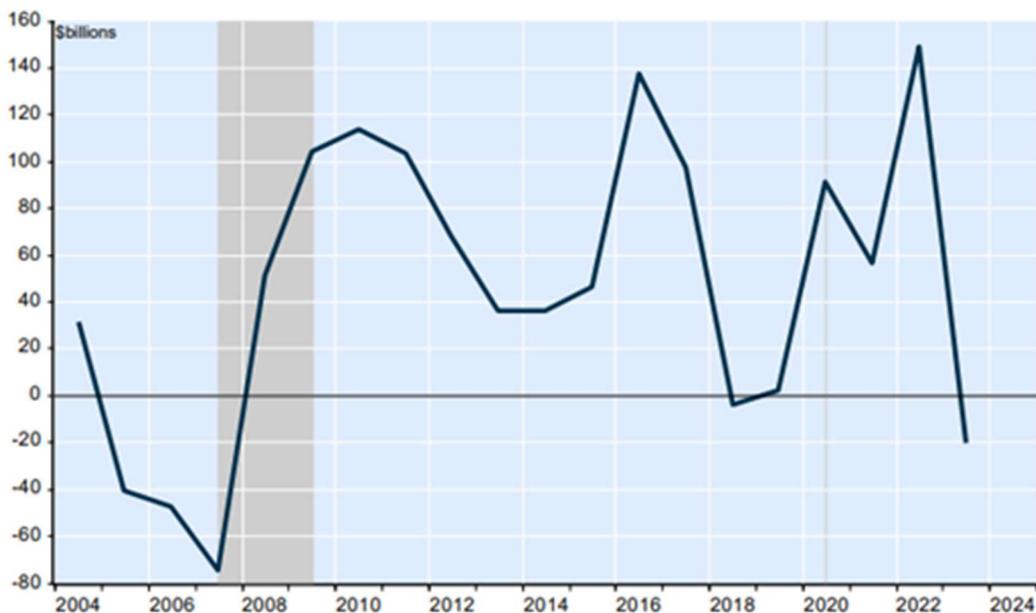
Ratio of Canada and U.S. real GDP per capita on a PPP basis



NBF Economics and Strategy (data via [World Bank](#))

Canada: Bleeding capital by the most since 2007

Net international transactions in securities (foreign less Canadian purchases of all securities)

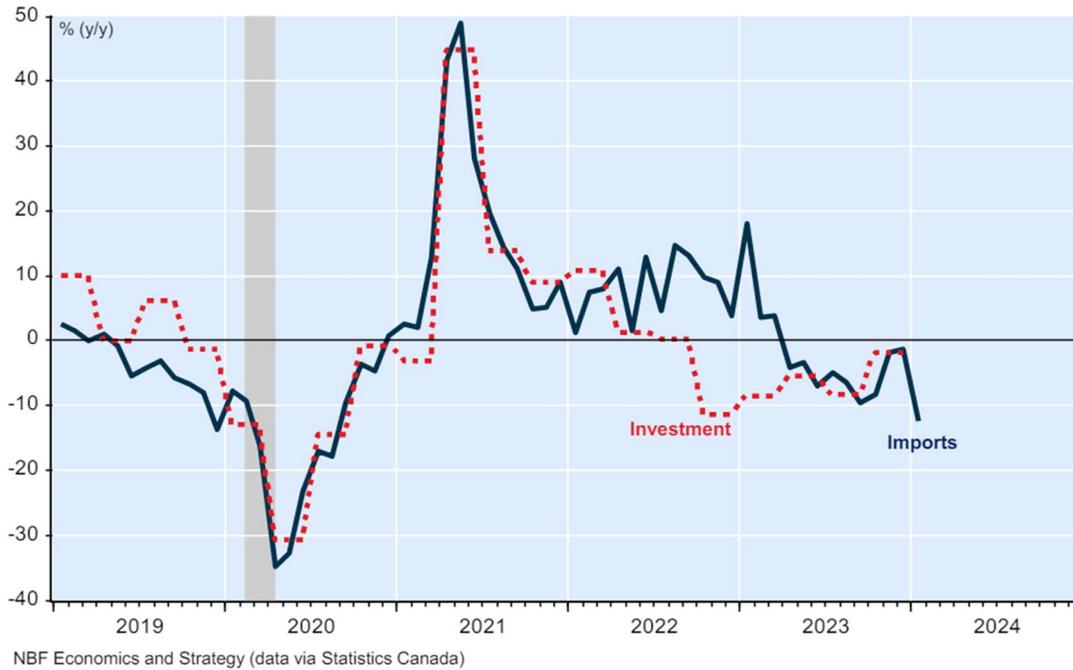


NBF Economics and Strategy (data via [Statistics Canada](#))



Canada: Business investment continues to fall

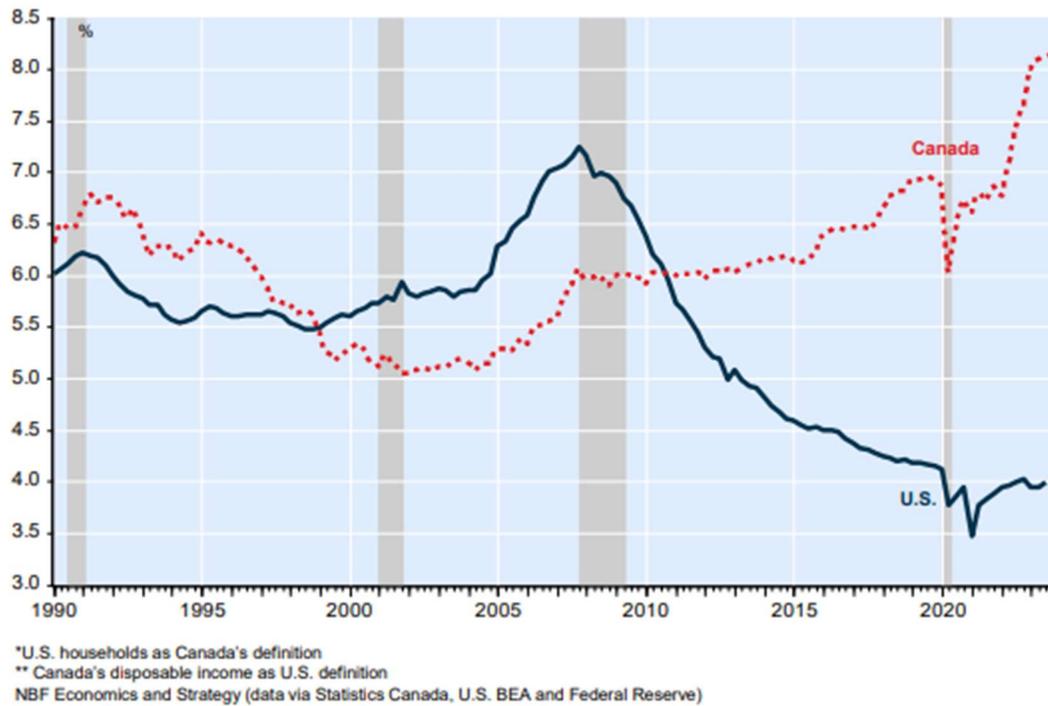
Volume imports of machinery & equipment vs. business investment in machinery & equipment



Encouraging immigration (a good thing) while discouraging construction increases demand vs. flat supply = Prices rise. Productivity costs Canadians.

Canada & U.S.: Household* mortgage debt service

Interest and capital payments as a % of household disposable income**



*U.S. households as Canada's definition
 ** Canada's disposable income as U.S. definition
 NBF Economics and Strategy (data via Statistics Canada, U.S. BEA and Federal Reserve)



Canadian Federal Budget 2024: Here we go again.

Budget 2024 Highlights & Commentary:

MNP:

<https://www.mnp.ca/en/insights/directory/2024-federal-budget-highlights#>

Financial Post:

<https://financialpost.com/news/canada-budget-2024-charts-tell-what-you-need-to-know>

NBF:

<https://nbf.bluematrix.com/sellside/EmailDocViewer?encrypt=4ccc5daa-cc48-43a9-b9b3-f49432887ca8&mime=pdf&co=nbf&id=steven.hilberry@nbc.ca&source=mail>

CASE STUDY OF INFLATION AND TAX ON A SMALL BUSINESS OWNER

A client is a Doctor of Veterinary Medicine in Saskatoon. She is 43. Employed by a large clinic her current income is dependable, she's building a pension and has a clear path to retirement. She is pondering opening her own veterinary clinic. She asked how the recent changes in capital gains tax might impact the Canadian economy and her decision. I replied to her question in writing this week. I'll call her Dr. Jones. **WARNING: Get your attention hat screwed down tight. This will be a lot of data.**

Dr. Jones,

The recent changes in capital gains taxes for Canadian Controlled Privat Corporations (CCPCs) impacts your decision. Let's say you decide to quit your current position with salary, benefits and pension to run your own veterinary clinic. You risk income to your family so it's not a light decision. You give up security and tender your resignation.

Let's assume you're pondering leasing space vs. buying a building to run your clinic. You decide to direct a portion of your earnings into purchasing a building vs. leasing space. As owning is more expensive than leasing upfront, you'd experience an initial drag on your net earnings to your family. You hope over time, as you pay down the mortgage, your practice increases that your future practice costs, go down after the building is paid for and you'll have an asset to sell in retirement. None of this is guaranteed to occur. You take the plunge and buy the building. It would cost money upfront to buy and renovate to fit your needs.

Recall the seller pays tax on any profits they realized on their sale, paid a provincial property transfer tax, paid a real estate agent (who paid tax on earnings) and an accountant (who paid tax on their fee) to sort it all out.

Let's assume the building costs \$674,000 (like this one:

<https://www.realtor.ca/real-estate/26758652/520-45th-a-street-e-saskatoon-north-industrial-sa>)

You buy the building. While you no longer pay lease payments, you're now responsible for municipal/provincial property taxes, ongoing maintenance and renovation, insurance, heat/power, mortgage principal and interest payments. NOTE: Lease payments typically include 'triple net' = paying for property taxes, heat light and power so it's the maintenance, mortgage principal debt repayment and mortgage interest that are additional costs. One could view those payments as forced savings. The interest on mortgage debt is deductible. The principal portion of the payment is not. 100% of lease payments are deductible. Income is applied against the mortgage owed vs spent on your family is building your equity meaning forced savings – the rest is overhead. Those savings may not result in profits. The building might not gain in value enough to make it worth while. As you're in small business, with employee costs and liability risks, you decide to incorporate 'Dr. Jones Veterinary Services' into a Canadian Controlled Private Corporation (CCPC). You own all the shares in Dr Jones Inc. and Dr Jones Inc owns the practice and the building.

It takes 25 years to pay down the mortgage. You'd be age 68. Over those 25 years, you would have paid your employees wages, who paid income tax – and spent the after money – paying GST, paid GST on all the items the clinic needed, paid Provincial and Federal tax on your earnings, paid Provincial and municipal property tax. Your clinic creates new jobs and increases the tax revenue to governments. That's why a small business like yours is so important.

Fast forward: 25 years have passed, you're now 68 and thinking of retirement. You decide to sell the practice to a younger Vet on your team. As you don't want the hassle of being a landlord and the young Vet wants the building, you decide to sell the building along with the practice. Plus, the practice isn't likely to be worth nearly as much as the building might be.

What does the building need to sell for to get all your costs back, factored the decline in purchasing power from inflation?

Here is a historical inflation calculator via the Bank of Canada

<https://www.bankofcanada.ca/rates/related/inflation-calculator/>

We must be cautious with this calculation as the past 15 years have seen unusually low inflation around or under 2% per year.

*At the prevailing annual average rate of inflation of 2.23%, **\$674,000** spent 25 years ago in 1999 needs to be worth **\$1,170,000** in 2024 to keep pace with inflation. The building needs to gain **\$496,000 / 73.6% in price**. This 73.6% increase represents inflation. It doesn't factor in annual municipal/provincial property tax, maintenance, upkeep, insurance etc.*

Typical property tax rates are around 1% per year. The 1% is on the assessed market value each year, which reflects annual inflation. Maintenance, insurance costs typically reflect around 2-3% per year and reflect inflation. This takes the required breakeven annual average value price-growth rate to around 5% (2% inflation, 1% property tax, 2% maintenance & insurance).

We haven't factored mortgage interest yet. Let's add another 4% per year mortgage debt interest (caution: that is a below-average mortgage rate). We arrive at an annual growth rate required to break-even after costs and financing of around 9% per year.

The purchase price of \$674,000 must be worth \$5,811,956 to maintain the purchasing power of the initial outlay and all subsequent costs, an increase roughly 10-fold. As some of the costs are an alternative to leasing, one might accept something less than the full \$5.8 million end value. That total return requirement will enter in to selling decisions. If we look at the historical prices in Saskatoon, a 10-fold increase in price over 25 years might have happened! Could one have purchased a small commercial building for \$67,000 in 1999? If so, those gains to today's value of \$674,000 reflected inflation plus costs, nothing more. We aren't providing a time value to managing these costs either. That's on the business owner to factor into monthly practice revenue billing to clients. To clarify, in our required \$5.8 million, does not make a positive return above inflation and costs.

Inflation silently compounds the cost of everything destroying 'real' purchasing power. It can be hard to correctly attribute inflation in our daily lives. Long-term property investors, tend to forget the cost of repairing the front window when a drunk threw a rock through it 10 years ago. It's easy for governments to quietly sidestep blame. 'COVID happened and Russia attacked Ukraine'.

Despite these hurdles, there could be many good reasons for owning a building vs leasing it, including the ability to control your business expenses, and ending up with a lump of money when you sell. A lump of money may not equate to a great investment return, but it's still a lump of money. To be clear this a very rough example. There are numerous deductions, cost allowances, corporate capital dividend accounts, flow throughs, small business exemptions and other calculations that affect these results.

NOTE: If we run the same Bank of Canada inflation calculation for 1974 – 1999, the required end value for \$674,000 to match inflation alone is \$2,460,634 = 5.32% avg inflation, almost exactly twice our first calculation. Much of my career saw inflation well above 2%, explaining my caution. Inflation is a big deal.

Real Estate selling prices reflect inflation. That's not guaranteed but it usually happens. Why? Baring a broad decline in the community (as happened in small towns on the prairies and BC's Interior in the past) if the price doesn't grow with inflation, construction is discouraged reducing supply. Eventually existing properties are driven up in price. Sound familiar?

Back to your retirement.

You decide to sell the building. How is the building sale treated for tax purposes? 100% of the gain is treated as a 'capital gain' (not the inflation adjusted value). So... in our \$5.8 million end value vs. \$674,000 start value, the difference of \$5,137,956 is a 'capital gain'. Capital gain's tax is applied on this difference between purchase and sale. As the end value in our example merely represents purchasing power breakeven, any tax on that amount is effectively taxing the original capital (that itself resulted from after-tax savings)



Prior to the April 2024 Federal budget, 50% of capital gains generated inside a corporation were taxable, the other half being ignored. The terminology for the portion of the capital gain included in income is an 'inclusion rate' of 50%. In our example, 50% of the gain, or **\$2,568,978** is 'included' into income for the corporation in the year of sale. The tax rate on this income would be roughly 50%. The corporation would have owed **\$1,284,489** in tax. The tax equated to **22.1% of the pre-tax proceeds**. I'll repeat that as this is on the 'real' breakeven value it also represents 22.1% of the initial investment 25 years ago. The after-tax proceeds are **\$4,527,467**.

The new rules raise the inclusion rate to **66.6%**. **\$3,391,050** is now taxable. The ending tax bill is now **\$1,710,939**. The increase in tax is **+\$426,450**. The new net tax equates to **29.4%** of the pre-tax sale value. The increased tax represents 7.34% on 22.1% = a 33.2% tax hike.

The after-tax proceeds will now be **\$4,101,017** resulting in a 9.4% reduction in net proceeds (your retirement nest egg is 9.4% smaller). \$426K increase feels like a lot of money. That's equal to seven \$60,000 employee salaries. If you realized you were suddenly going to get \$426,000 less, you'd look hard at your staffing costs a year or so in advance. You certainly wouldn't hire more staff in the years near your retirement.

CONCLUSIONS:

1. This is all discouraging. That's the common response from our clients.
 - a. Why bother with the hassle? Just lease, let someone else take the hit.
 - b. Deciding not to buy reduces demand for new building construction.
 - c. Less buildings constructed means existing buildings become more valuable – which they must (see next point) and reduces construction jobs.
2. If you own the building, you now require the selling price to be **7.34% higher** to breakeven.
 - a. This tax will force you to increase your asking price, reduce your profits, maybe discourage selling.
 - b. The increase in tax is an increase in costs IE: inflation.
3. Increased taxes are....
 - a. Discouraging.
 - b. Inflationary.
 - c. Punish risk taking and long-term investment.
 - d. Reduce the motivation to own a business vs staying where you are.
 - e. Saskatoon suffers from less job opportunities.

THE POLITICAL NARRATIVE:

In an attempt to sell these higher taxes, Finance Minister Freeland trotted out the trope 'Nurses are paying a higher marginal tax rate than millionaires. That's not fair'.

This argument compares the 22% tax rate (on \$5.8 million) paid by our 'millionaire' vs the 30% tax rate on a nurse's income at the hospital. This view says raising the net capital gains tax to 29% on 'millionaires' is 'more fair' but still too low".

Really?

- Recall the above millionaire was a) just getting their money back and b) waiting through 25 years of inflation to get it.
- They did without that \$674,000 for 25 years, generated compounding local economic benefit to Saskatoon and now paid a huge lump of tax in actual dollars on selling.
- Our millionaire is losing 29% of their end capital meaning 29% their original purchasing power to tax.
- Our millionaire doesn't have a pension. The resulting \$4.1 million at a 4% return will generate roughly \$164,000 pre-inflation per year income.
- Our nurse is paying tax on previous year's annual income, losing on average 7-mos time value in a year inflation effect. Salaries follow inflation.
- Our nurse benefits from an inflation-indexed government pension mostly at the risk of government (taxpayers). Typical nurse pension payouts are around \$60,000 per year, implying \$1.5 million invested by the paying government (taxpayers) to cover it.
- Why is the requirement to bring lower taxes UP? Why not bring higher taxes DOWN? Answer: Despite these higher taxes, budget are still projected, following deficits past.

That's why this tax change is such a problem.

Steve Hilberry

The above granular example of the result of government tax and spend behaviour depressing local investment has weighed on international investment flows into Canada as well (see the first section). The Loonie is near decade lows. A weak Loonie is inflationary. We pay more for oranges. Round and round.

WHY WE REMAIN OPTIMISTIC

Canada's natural resources bounty, small, educated young and growing population, with room to grow within a stable economy dominated by rule of law and peace and our distance from hostilities should remain in our favor. Ceasing self-inflicted injury would help.

While we think our government debt and economy has been poorly led of late, international investors (with more money than we have) continue to view Canada as a safe place to lend money to but not a great place to take risks (invest)...at this time. We see the Loonie as cheap and our economy as undervalued.

We suspect a change in government is coming. There could be a change in international investor appetite. Hold on to your hat!

Have a Great Weekend

Steve & Anna Hilberry



Steve Hilberry
Wealth Management Advisor, CIM

Anna Hilberry
Wealth Management Advisor, CIM

FOR THE RECORD April 19, 2024

DOW INDUSTRIALS:	37,921
S&P 500:	4,962
S&P/TSX COMP:	21777
WTI:	\$82.25
LOONIE IN \$USD:	\$0.7271 \$US

April 19, 2024

© NATIONAL BANK FINANCIAL. All rights reserved 2019.

[Terms of Use](#) [Confidentiality](#) [ABC's of Security](#)

National Bank Financial - Wealth Management (NBFWM) is a division of National Bank Financial Inc. (NBF), as well as a trademark owned by National Bank of Canada (NBC) that is used under license by NBF. NBF is a member of the Canadian Investment Regulatory Organization (CIRO) and the Canadian Investor Protection Fund (CIPF), and is a wholly owned subsidiary of NBC, a public company listed on the Toronto Stock Exchange (TSX: NA).

The particulars contained herein were obtained from sources we believe to be reliable but are not guaranteed by us and may be incomplete. The opinions expressed are based upon our analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein. The opinions expressed do not necessarily reflect those of NBF.

The securities or sectors mentioned in this letter are not suitable for all types of investors and should not be considered as recommendations. Please consult your Wealth Advisor to verify whether the security or sector is suitable for you and to obtain complete information, including the main risk factors. Some of the securities or sectors mentioned may not be followed by the analysts of NBF.

Sent by
Montreal Office
National Bank Financial
Wealth Management
1155 Metcalfe 5th Floor
Montreal, Quebec, H3B 4S9
Phone: 514-879-2222

Toronto Office
National Bank Financial
Wealth Management
130 King Street West Suite 3200
Toronto, ON, M5X 1J9
Phone: 416-869-3707



HILBERRY GROUP