

## **LEC 03 - Planning Your Tax Strategy**

### **Learning Objectives:**

1. Describe the importance of taxes for personal financial planning
  2. Illustrate how federal income taxes are computed by completing federal income tax return
  3. Select appropriate tax strategies for different financial and personal situations
  4. Identify tax assistance sources
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### **Filing Your Federal and Provincial Income Tax Return:**

#### **Who Must File?:**

- All residents of Canada must file a federal income tax return for any year in which they have a balance of taxes owing
  - Your province of residency as of December 31 of the taxation year determines which provincial income tax return you are required to file
  - Canadian residents are taxed based off their worldwide income
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### **Steps for Computing Taxable Income and Tax Liability:**

1. Determine total income
  - Total income consists of 5 main components:
    - i. Employment income → Salary
    - ii. Net business income → Profits from a business you own
    - iii. Investment income → Dividends from investments
    - iv. Taxable capital gains → Selling stocks that have appreciated
    - v. Other income → Retirement income, Old age security, Canada pension plan, Employment insurance payments
2. Calculate net income
  - Net income is the total income reduced by certain deductions such as:
    - i. Contributions to RRSP, RRP, and IPPs
    - ii. Union and professional dues
    - iii. Childcare expenses
    - iv. Disability support deductions
    - v. Moving expenses
    - vi. Other deductions → business investment loss, interest paid on loans, employment expenses
3. Calculate taxable income
  - The net amount of income after allowed deductions on which tax is computed:
  - Additional losses and deductions carried from prior years
    - i. Security options deduction (also known as the stock option deduction)
    - ii. Capital gains deduction
    - iii. Net capital loss of prior years
    - iv. Other deductions

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<b>Taxable Income</b>	<b>Tax Rate</b>
\$0 - \$50,197	15%
\$50,197 - \$100,392	20.5%
\$100,392 - \$155,625	26%
\$155,625 - \$221,708	29%
\$221,708 and up	33%

**4. Calculate federal taxes owing**

- Taxable income is basis for computing amount of your income tax owing
- Tax rates and tax credits are used to compute taxes payable

**Marginal Tax Rate:**

- Rate of tax paid on the next dollar of taxable income
- For example, suppose you earn \$53,000 of taxable income
  - Your 2022 federal tax liability is calculated as 15% on the first \$50,197, while the remaining \$2,803 is taxed at 20.5%
  - In total, your federal taxes equal 15% of \$50,197 = \$7,529.55 and 20.5% of \$2,803 = \$574.62 for a total of \$8,104.17 before the consideration of any tax credits
  - Your federal tax rate is 20.5%, the rate applied to the next dollar of taxable income

**Average Tax Rate:**

- $Average\ Tax\ Rate = \frac{Total\ Tax\ Due}{Total\ Taxable\ Income}$
- Continuing the previous example, the average tax rate would be  $\$8,104.17 \div \$53,000 = 0.1529 = 15.29\%$

**5. Calculate Net Federal Tax**

**Tax Credit:** An amount subtracted directly from the amount of taxes owing

**Non-refundable Tax Credits:** Subtracted from the amount of taxes owing but can never reduce the amount owing below 0

**Refundable Tax Credits:** Subtracted from the amount of taxes owing but can reduce the amount owing below 0, which results in a refund from the government

**LEC 03 - Planning Your Tax Strategy****Examples of Tax Credits:**

<b>Non Refundable Tax Credit</b>	<b>(\$)</b>
Basic Personal Amount	14,398
Spouse or Common-Law Partner	14,398
→ Eliminated when spousal income exceeds.....	14,398
Age Amount	7,898
→ Reduced when income exceeds.....	39,836
→ Eliminated when income exceeds.....	92,479
Disability Amount	8,870
Disability Amount Supplement for Taxpayers Under 18	5,174
→ Reduced when total child care expenses exceed.....	3,030
→ Eliminated when above expenses exceed.....	8,204
Canada Caregiver Credit (Infirm Child Under 18)	2,350
Canada Caregiver Credit (Infirm Child Over 18)	7,525
→ Reduced when relatives' income exceeds.....	17,670
→ Eliminated when relatives' income exceeds.....	25,195
Pension Income Amount - Lesser of eligible pension income OR...	2,000
Medical Expense - Excess of the lesser of 3% of net income OR...	2,479
Medical For Other Dependants - Excess of the lesser of 3% of the dependent net income OR...	2,479
Eligible Adoption Expenses - Max per child	17,131
Canada Home Buyer's Amount	10,000
Canada Employment Amount	1,287
Indexing Factor for 2022	1.022

**Example - Computing Taxable Income (1):**

Brianna arrived at the following tax information:

- Gross salary → \$57,750
- Interest earnings in her TFSA → \$225

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- Eligible dividend income → \$100
- Basic personal amount → \$14,398
- Union dues → \$3,890
- Moving expense (50km for employment) → \$1,150

What amount will Brianna report as taxable income?

- Gross salary → Taxable
- TFSA → Not taxable
- Dividends → taxable
  - Note: when reporting dividend earnings, we multiply public company dividends by 1.38 and private company dividends by 1.15, this is known as dividend gross up
- Basic personal amount → Tax credit
- Union dues → Tax deduction
- Moving expenses → Tax deduction

$$\begin{aligned} \text{Income} &= \text{Salary} + 1.38 \cdot \text{Eligible Dividends} - \text{Union Dues} - \text{Moving Expenses} \\ \text{Income} &= 57,750 + 1.38(100) - 3,890 - 1,150 \\ \text{Income} &= \$52,848 \end{aligned}$$

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#### **Example - Computing Average Tax Rate (2):**

What is the average tax rate for a person who paid taxes of \$11,130 on a total taxable income of \$66,012?

$$\text{Average Tax Rate} = \frac{\text{Total Tax Due}}{\text{Total Taxable Income}} = \frac{11,130}{66,012} = 0.168 = 16.8\%$$

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#### **Example - Determining a Refund or Taxes Owed (4):**

Based on the following data...

- Net income → \$53,580
- Deductions to determine net income → \$11,420
- Federal income tax withheld → \$6,784
- Total non-refundable tax credit amounts, excluding medical expenses → \$14,398
- Medical expenses → \$2,300

Will Ann Wilton receive a federal tax refund or owe additional taxes in 2022?

- Deductions is a trick since they were already used to calculate net income
  - Therefore, we ignore them
- Federal tax rate is a refundable credit

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- Total non refundable tax credits excluding medical expenses is the basic personal amount
  - The eligible deduction is  $14,398 \cdot 0.15 = 2159.70$
- Medical expenses are a credit for the minimum of 3% of net income or 2479
  - $53,580 \cdot 0.03 = 1,607.4 < 2,749$
  - Therefore, the eligible amount is  $2300 - 1607.4 = \$692$
  - Multiplying by 15% since it is a credit gives  $692 \cdot 0.15 = \$103.89$  of eligible deductions
- Credits
  - Basic personal credits
  - Multiply all credits by 15%
  - Medical expenses of 692.60  $\rightarrow$  103.89
  - Tax refund since taxes are smaller than withheld taxes
  - Tax refund of 824.52

$$Total Tax = 0.15(50,197) + 0.205(53,580 - 50,197) = 8,223.07$$

$$Total Deductions = Total nonrefundable tax credits + Medical credit$$

$$Total Deductions = 2159.70 + 103.89 = 2263.59$$

$$Tax Payable = Tax payable - Total Deductions$$

$$Tax Payable = 8,223.07 - 2263.59 = 5959.48$$

Since the tax payable (\$5,959.48) is less than the tax withheld (\$6,784.00), Ann will receive a refund since more cash was withheld for taxes than needed

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#### **Making Tax Payments:**

- Can be paid in installments

#### **Source Withholding:**

- Employees withhold from source to pay income tax, CPP, and employment insurance contributions
- Reported to you on your T4
- Can reduce source withholding

#### **Deadlines and Penalties:**

- Must file by April 30 of each year
- Automatic 5% penalty on balance owing if late

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#### **Tax Planning vs. Tax Evasion:**

**Tax Planning:** The use of legitimate methods to reduce one's taxes

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**Tax Evasion:** The use of illegal actions to reduce one's taxes

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### **Registered Retirement Savings Plan (RRSP):**

- Can contribute up to 18% of previous year's earned income (\$32,780 maximum for 2023)
    - Contributions are tax-deductible
    - Unused room can carry forward
  - Contributions grow tax free
    - Withdrawals are tax free
    - Withdrawals do not increase contribution room
  - No lifetime contribution limit
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### **Tax Free Savings Account (TFSA):**

- Can contribute \$6,500 as of 2023
    - Regardless of amount contributed to RRSP/RSP
    - Unused room can carry forward
  - Contributions grow tax free
    - Withdrawals are tax free as well
    - Withdrawals create contribution room for future years
  - Gains/withdrawals not considered when determining eligibility for federal income tax benefits (OAS) or credits
  - TFSA is subject to the same investment restrictions as RRSP/RSP
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### **First Home Savings Account (FHSA):**

- Designed to help Canadians save for a principal residence
  - Can contribute \$8,000 annually with a \$40,000 lifetime limit within 15 years of starting
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### **Tax Deferral Techniques:**

- Defer taxation of income until a later date when combined average tax rate will be lower
- During deferral period investment income earned can be reinvested tax free
  - Registered Retirement Savings Plan
  - Registered Pension Plans
  - Individual Pension Plan

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- Registered Education Savings Plan
  - Deferred Profit-Sharing Plan
  - Investing in capital assets
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#### **Tax Issues Important to Students:**

1. Learn how to report income from scholarships, bursaries, fellowships, grants, and RESPs
  2. Get common deductions such as moving expenses, childcare expenses, and interest paid on student loans
  3. Non-refundable tax credits such as tuition and education amounts
  4. Other tax credits such as GST/HST credit and Canada Child Tax Benefit
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#### **Tax Information Sources:**

- Tax information sources and assistance can be found at...
    - a. Canada Revenue Agency
    - b. Libraries and bookstores
    - c. Internet sites
    - d. Tax publications
    - e. Tax preparation software and electronic filing
    - f. Tax preparation services
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#### **Tax Audits:**

##### **What if your return is audited?:**

- A tax audit is a detailed examination of your return for Canada Customs and Revenue Agency
  - More information is requested
  - Keep detailed records
    - Receipts
    - Cancelled cheques
    - Evidence to prove amounts claimed
    - Avoid common filing errors

##### **Types of Audits:**

1. Desk Audit
  - Inquiry mailed asking you to clarify or document
2. Field Audit
  - Agents visit to have access to records
  - May request only specific information

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- You should seek assistance from a professional advisor
- Generally not a cause for alarm