Snapshots™

TAXES 101

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ZOOM IN: Introduction to Taxes

Learn more about your tax system, how to invest with tax efficiency and what you can do to reduce the taxes you pay over a snapshot of lifecycles.

The object is to keep more of both your income and your assets so you can continue to build and sustain wealth.

You'll learn many new terms and concepts, and that's very important because, for many high-net-worth Canadians, the biggest expense in a lifetime is the taxes you pay. Your personal tax rate, depending on where you live, can often exceed 50%.

It's also important to understand your tax-filing obligations. Canadian residents are taxed on their worldwide income, expressed in Canadian funds, for the period January 1 to December 31 each year. This is reported on a personal tax return, the *T1 General Income Tax and Benefits Return*, usually by April 30 every year[1], and can include a variety of sources:

The Canadian tax system is based on self-assessment. It is up to you to properly report your income and capital dispositions, and the burden of proof is on you to prove how you calculated your taxes payable. Failure to report world income, as well as capital transactions, can result in large penalties and expensive interest costs.

[1] A filing due date of June 15 is allowed for unincorporated business owners.

Tax Planning: What matters is what you keep

While it is the individual who must file a tax return in Canada, most families make financial decisions about their assets as a household unit over a period of multiple lifecycles. Many assets will produce income; others will appreciate in value. Yet others have debt attached to them. It's important to keep track of all those circumstances, as they will likely have tax consequences.

We generally do this by compiling a Personal Net Worth Statement. An example follows:

Your personal net worth statement

Measuring your personal net worth (PNW) periodically—once or twice a year—provides an excellent scorecard for your investing activities. You can become wealthier by investing in assets that accumulate value over time. When they provide you with income for consumption and/or reinvestment, they perform even better, especially when you consider the source of income earned and its tax efficiency, discussed later in this paper.

Another way to become wealthier is to manage and reduce debt. Some interest costs on your debt will be tax deductible; generally, if incurred to earn income from property – so long as that property is not held in a registered account, like a TFSA or an RRSP. Interest on money borrowed to invest in those plans is not tax deductible.

What's your PNW scorecard?

Your advisor can help you create and analyze your accountable results as part of your financial planning.

Financial Assets	Value
TFSAs	
RRSPs, RRIFs, DPSPs	
RESPs	
Non-registered: Stocks & Bonds	
Other	
Non-Financial Assets	**Value**
Principal Residence	
Other Real Estate	
Vehicles	
Contents of Properties	
Business Equity	
Total Assets	

Liabilities	Value
Credit card debt	
Line of Credit	
Mortgages	
Car Loans	
Student Loans	
Other Loans	
Tax Debt	
Total Liabilities	

Personal Net Worth (Assets – Liabilities)	

Family Net Worth Statements. Families that are interested in discussing estate planning will want to develop Family Net Worth Statements. This will help you better prepare for the right time to transfer assets from one family member to the next.

Progressivity in tax rates

In Canada, the more you earn, the more you pay. This is illustrated in the chart below, depicting federal tax rates.

Canadians file tax returns as individuals. Each person has access to a Basic Personal Amount (BPA) on their federal return. This allows for a certain level of "tax-free earnings" – in the vicinity of $13,000 on the federal tax return. This amount is partially indexed to inflation annually. Canadians also pay provincial taxes based on their province of residence as of December 31. Provincial taxes are also offset by a BPA, although the amounts generally differ, and are not always indexed to inflation.

Because each person has access to the BPA and lower earners will pay less taxes than higher earners, families often want to income split. There are strict rules against this.

However, there are some tax advantages to filing taxes at the same time, especially by spouses, as the government allows for some limited opportunities to split pension, business and investment income, which will give a better after-tax result. It is also necessary to combine family net income to calculate certain tax credits.

Federal tax brackets and rates 2019, 2020, 2021

2019 Brackets	2019 Rates	2020 Brackets	2020 Rates	2021 Brackets	2021 Rates
Up to $12,069	0	Up to $13,229	0	Up to $13,808	0
$12,069 to $47,630	15%	$13,230 to $48,535	15%	$13,809 to $49,020	15%
$47,630 to $95,259	20.5%	$48,536 to $97,069	20.5%	$49,021 to $98,040	20.5%
$95,259 to $147,667	26%	$97,070 to $150,473	26%	$98,041 to $151,978	26%
$147,667 to $210,371	29%	$150,474 to $214,368	29%	$151,979 to $216,511	29%
Over $210,371	33%	Over $214,368	33%	Over $216,511	33%

NOTE: Computation of Federal Tax Brackets and Rates 2021

Bracket #	Income Over $216,511	Tax Rates	Income Between $151,979 & $216,511	Tax Rates	Income Under $151,979	Tax Rates
0	Up to $12,421	0%	SEE NOTE BELOW	0%	Up to $13,808	0%
1	$12,422 to $49,020	15%	SEE NOTE BELOW	15%	$13,809 to $49,020	15%
2	$49,021 to $98,040	20.5%	$49,021 to $98,040	20.5%	$49,021 to $98,040	20.5%
3	$98,041 to $151,978	26%	$98,041 to $151,978	26%	$98,041 to $151,978	26%
4	$151,979 to $216,511	29%	$151,979 to $216,511	29%	$151,979 to $216,511	29%
5	Over $216,511	33%	Over $216,511	33%	Over $216,511	33%

NOTE: In simple terms, the "Minimum BPA" for 2021 is $12,421 for earners in the 5th tax bracket, and this amount will be partially indexed to inflation every year. For those with taxable income **under** the 4th tax bracket, the "Maximum BPA" is available. For 2021 this number features an enhancement of $1,387 for a total Maximum BPA of $13,808.

Taxpayers in the 29% bracket will have the BPA enhancement reduced by a fraction that first calculates how much of their income is between the bottom of the 4th and 5th tax brackets and determines the Maximum Enhancement. If income is $200,000 for example, the enhancement is $209 for a total BPA of $12,298 plus $209 or $12,507.

Income between the 4th and 5th tax bracket ($216,511 - $200,000)	16,511
Total income between 4th and 5th tax bracket ($216,511 - $151,979)	64,532 = .25 x $1,387 = $346.75

For 2021, the minimum BPA is $12,421, with an enhancement of $1,387 for a total BPA of $13,808.

Source of income matters

Income to be reported can come from a variety of sources, not all of which are taxed alike. There are two primary sources of taxable income:

Income-producing assets	Income
Financial • Registered Accounts • Non-Registered Accounts	**Actively earned** • Employment • Self-employment
Non-financial • Business • Real Estate	**Passively earned** • Interest, dividends, rents & royalties • Gains on disposition of assets

It is important to pay attention to each individual's tax bracket and marginal tax rate – how much will be paid on the next source of income. You will see below that diversity in your source of income can help reduce your overall taxes.

Income source diversification is so important, especially when provincial taxes are added to the mix. You can see below, at top marginal rates, the West beats Ontario in after-tax returns:

Income Source	B.C.*	Alberta*	Ontario*
Ordinary Income. This includes interest and foreign dividends, pensions and employment income net of deductions and credits, net rental income and net income from proprietorships.	49.80/53.50%	47.00/48.00%	51.97/53.53%
Dividends – Non-eligible. These are paid by Small Business Corporations on income eligible for the Small Business Deduction (SBD) or from investment income.	44.63/48.89%	41.16/42.31%	45.95/47.74%
Dividends – Eligible. These are paid from income subject to the general corporate tax rate and excludes investment income.	31.44/36.54%	32.93/34.31%	37.19/39.34%
Capital Gains. Currently, 50% of taxable gains on the disposal of income-producing assets is included in the investor's income.	24.90/26.75%	23.50/24.00%	25.98/26.76%

*At the federal level, the highest rate begins at $216,511. BC, Alberta and Ontario have a high tax rate on incomes over $222,420, $314,928 and $220,000 respectively in 2021. Rates above these income levels are shown to the right.

Income splitting and clawbacks

When planning future income sources with your advisor, it's important to think about whether you qualify for any social benefits – refundable tax credits such as the Canada Child Benefit, for example, or Employment Insurance (EI) or in the case of seniors, the Old Age Security (OAS). These benefits are "clawed back" or reduced when income goes over a certain threshold. That's called "income-testing," and most high-net-worth individuals will not qualify for these benefits. Still, circumstances can change from year to year, so it's important for you to understand this concept. These clawbacks are based on the size of "net income" on your federal tax return.

It is important to keep net income under the income ceilings below to get the most out of the following provisions:

Do you qualify for income splitting?	Is income in clawback zones?
Investments: Inter-spousal investment loans, transfer of dividends or business involvement	**OAS:** Individual Net Income between: $79,845 and $129,417*
Public and Private: Pension Withdrawals	**Age Amount:** Individual Net Income between: $38,893 - $90,313*

*In 2021

Investing with tax efficiency

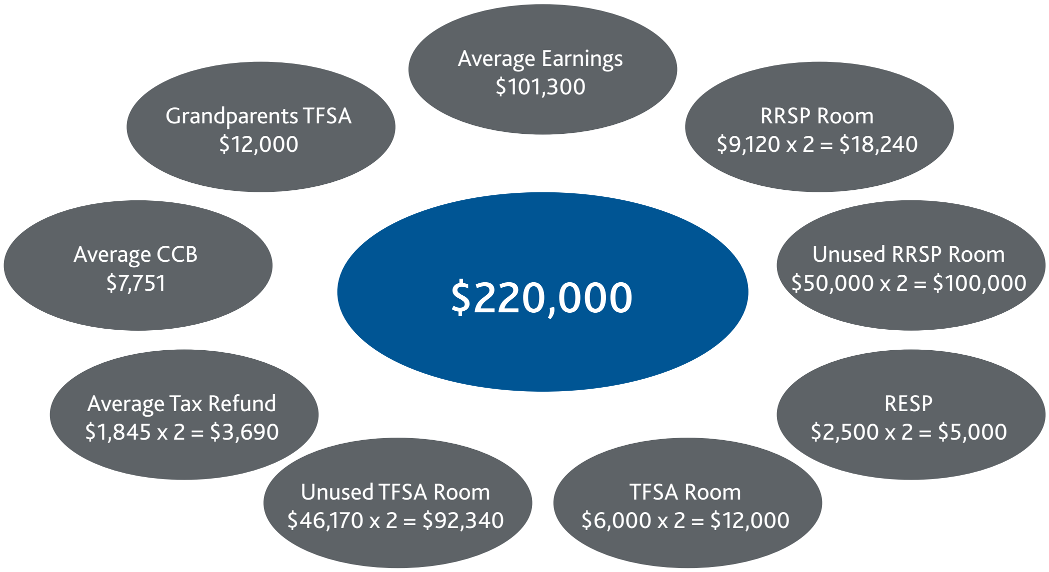
Assessing Your Tax Efficiency Gaps

The first step in tax-efficient investing is to assess the opportunities you – and every one of your family members – have to take advantage of investments that offer tax advantages. Depending on your age, income and family composition, this breaks down into eight opportunities, specifically:

1. RRSP contributions
2. TFSA contributions
3. RESP contributions
4. Reinvestment of any tax refunds received
5. Reinvestment of any refundable tax credits or social benefits received
6. RDSP (Registered Disability Savings Plan) contributions
7. Investments in tax-exempt insurance policies
8. Investment in a tax-exempt principal residence

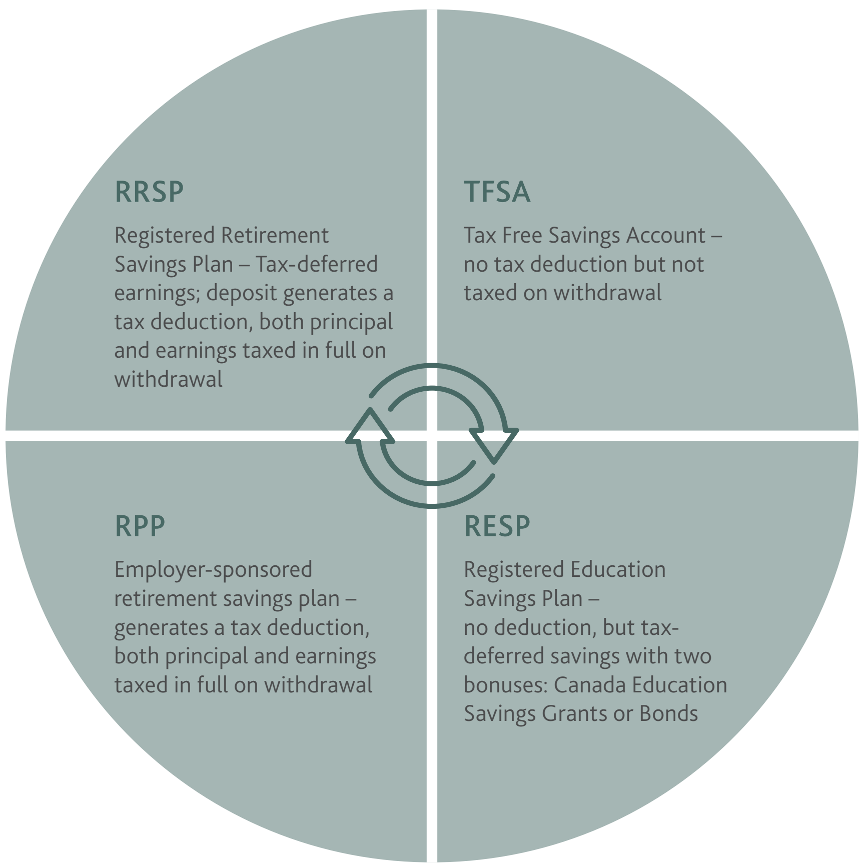
There is also an opportunity to transfer assets to other generations; for example, to gift other adults in the family the money to purchase a TFSA. The diagram below depicts the tax-efficiency gaps for an average family in Canada:

Average Middle-Class Family of Four (2020)



Most families will have unused contribution room in tax-efficient investment vehicles like RRSPs, TFSAs, RESPs. The average unused room in an RRSP, for example, is $50,000 per taxpayer, according to Statistics Canada.

Work with your advisor to better understand the definition of each of these accounts and then determine the potential "tax-efficiency gaps" for each investor in the family.



Then develop and execute a strategic investment plan to top up your opportunities to accumulate money in tax-preferred accounts. The order of your investment strategies will depend on your age, income level and sources, and the availability of funds for investing.

There are many options to help you with that. For example, if you make an RRSP contribution, you'll usually get a bigger tax refund (or pay less tax). Taking those tax savings to fund other tax-preferred investment vehicles – like a TFSA, for example, can really pay off.

Or, through the astute use of tax deductions and credits, shore up education funding in an RESP. This will, in turn, attract a generous Canada Education Savings Grant. Or take the opportunity to pay down debt if interest costs are not deductible. Draw the tax-efficiency gaps in a visual depiction for a more impactful discussion.

The fictional average family above, for example, has tax-efficiency gaps that exceed $220,000 in 2020.

Digging for all your tax deductions and credits

And that brings us to the four pillars of tax-efficiency planning. The last one – really digging for all your available tax deductions and credits – will be the subject of many of the tax tips you'll read about in this White Paper. It's also something you should discuss with your tax and financial advisors.

1. Manage Tax Brackets & Rates	**3.** Invest with Tax Efficiency
2. Split Income and Reduce Clawbacks	**4.** Maximize Deductions and Credits

One more thing: tax entities

In some cases, high-net-worth families and their family members, including spouses and children, each earn income from a variety of entities. They can be taxed as an individual within a corporation, receive dividends from a corporation or various distributions from one or more trusts.

It is the integration of these tax systems – the personal/trust and the corporate tax regimes – that is considered when discussing the management of family wealth. It is important to avoid double taxation, which the integration of the two systems attempts to do and to pay attention to the valuation of assets if they are to be transferred from one structure to another.

Notes

Notes

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