Debt Management: General Tax Strategies

General Tax Strategies

By: Joe the Investor

Tax planning is highly dependent on where you live, but there are general strategies that apply to tax systems in many countries. Please check with the tax code that applies to you – there may be more than one. The mindset surrounding taxes is important in understanding what the motivation behind a tax is. Taxes should be treated as the ongoing cost of making money. They should always be accounted for prior to making an investment, taking on employment or forming a business. It is not what you earn in revenue that matters, it is what you get to keep net of all expenses – and this includes taxes. If you think in this format, you will know what to expect from your tax situation, and you will know if the activity you are undertaking is worthwhile. Going to work should also be viewed this way. Take note of how much money you get to keep after taxes. If you are getting a promotion, or choosing between two jobs, the one with the most income after all taxes and expenses should be the one you choose. This assumes that everything else about the two choices is the same, which is very rarely the case. The purpose of the prior statement is to raise awareness of strategic thinking when it comes to taxes. If you are going to take a contract job or run a business versus salaried employment, these choices become more important. The next paragraphs outline general concepts that would apply to most situations because they are fundamental to how a tax system is constructed.

Timing is Important

You will notice that taxes are always filed in annual periods, or quarterly periods if you report or pay quarterly. Notice as well that the more money you earn, the higher the percentage of tax you pay on that extra money you earn. This is what is called a "progressive tax system" which is how the Canadian tax code is constructed. If tax rates are flat over all incomes, meaning that the percentage of taxes paid are the same regardless of how much money you earn, this strategy would not apply in the same way. In a progressive system, timing is important because if you claim $100,000 in income in a single year, you will pay more taxes than claiming $100,000 in income spread over 2 years. If you have an option to claim income over more tax periods, you will pay fewer tax dollars.

Are you getting a tax refund? Using the idea of the annual period, whatever is deducted throughout the year is then matched with a calculation that is done at the end of the tax period. If you paid more throughout the period than you are required to pay, you would get a refund. If you pay less than the amount required, you would have to pay an additional payment when the end of the period arrives. If you are deducting a lot of taxes in advance, you would tend to get a refund. The downside is that you are not earning interest on the money. Interest rates are very low now, so this may not be worth thinking about, but as rates rise, giving the government money in advance will be more expensive. If you are a savvy investor, and you can invest these taxes for a portion of the year before remitting them to the government, this is income you would not have otherwise been able to generate. If you are paying an additional payment at the end of the year, you are holding onto your money longer. Other factors to consider on this topic are whether paying a larger tax payment at the end of the tax year is disruptive to your cash flow. If you are borrowing money to pay your taxes, this is an additional cost which is over and above your required tax payment.

RRSPs and Tax Timing

Registered Retirement Savings Plans and related accounts like the RESPs and RRIFs are tax timing vehicles. You would get a tax deduction upfront and pay taxes later – in the year that you take money out of the tax shelter. Keep in mind that your tax situation when you put money into the tax shelter can be different than when you take money out. The tax code itself may also be different at both times. This is hard to plan for, but it is usually assumed that taxes will rise as time goes by. The ideal scenario is to contribute to an RRSP when your income is at its highest, and withdraw it when your income is at its lowest. This would translate into the biggest deduction upon deposit, and smallest tax burden upon withdrawal. The frequency of your withdrawal can also affect how much taxes you pay within the tax year. The larger the lump sum withdrawals, the higher the rate of taxes charged upfront. When the tax year ends, the taxes payable will be adjusted to the same amount regardless of this initial deduction. Throughout the year however, you can either pay the tax man in advance, or pay the tax man more at year end. If you are able to generate return within the tax year, delay the tax payment as long as you can and generate that extra income.

Type of Income and Associated Risk is Important

The tax code in Canada generally looks at three types of income. These are income (working as an employee and interest earned on guaranteed securities fits here), dividends, and capital gains. These three buckets represent 3 different levels of risk, and so there are 3 different sets of rules for each. Generally speaking, the more risk of loss that you have in creating this income, the less taxes you will pay, and the more likely it is that you can offset losses with your gains. Another aspect of these rules is that tax treatment of income is generally limited to the year in which it was earned. Once the year is over, you cannot revisit the taxes paid unless there is some error or recalculation due to a retroactive tax code adjustment. This concept is true for dividends as well. Once they are earned in a specific year, you generally cannot offset taxes in future years. With capital gains however, you are able to adjust past tax returns and future tax returns by carrying gains or losses to other years and “smoothing out” the amount of taxes paid over your lifetime. This is allowed because in order to incur capital gains, you will likely also incur capital losses, and by not allowing you to offset these losses, you are being taxed in an unbalanced way. The tax rate itself is highest for income, lower for dividends, and lower still for capital gains. Take note that these concepts hold true if you are talking about working and living in the same country. Once you get into foreign jurisdictions (like US dividends from US companies being paid to a Canadian), the rules may change. If you are affected by this situation, ask your tax preparer specifically about the situation you are in. As an example, if you are a Canadian being taxed on U.S. dividends, ask about the tax treatment in this specific situation. A U.S. resident earning that same dividend and in the same income scenario would be paying a different amount of taxes. Each pair of countries that are relevant to a situation (the country you are a resident or citizen of, and the country where the income is generated) are the countries I would inquire about. The situation will be different for each set of countries, and would apply if you earn income in more than two tax jurisdictions.

Federal and Provincial Taxes Are Important

In Canada, there are federal taxes and provincial taxes. The provincial taxes are calculated as a percentage of the federal taxes, so it is harder to predict the effect of these taxes in total. The best way to know how much taxes you are paying is to look at your historical tax returns and look at the entire amount paid in taxes. Other ways to prepare for this situation are to use tax calculators (1) or ask your tax preparer to estimate the combined effect. People tend to look at the federal rates but underestimate that there is also a provincial tax rate on top of that. Related to this idea, as you lower your taxable income, you will lower your federal taxes payable, and your provincial taxes payable. If your income is high, the provincial taxes will go up at a faster rate in a scenario where the provincial tax rates are progressive.

Tax Credits

If you are eligible for tax credits, use them as much as you can. These can change with every budget, and they sometimes expire – so an up to date source of tax information is highly advised here. Remember as well that governments issue tax credits to encourage investment in a sector, or change consumer buying patterns. When you see that the government is losing too much money from a credit, or the desired influence has largely been achieved, the credit will likely get modified or deleted. Make sure to look at the tax credit with respect to your whole tax situation. If you have to give up some other benefit to get the credit, or spend money you wouldn't have otherwise spent, this credit may not be worthwhile. If you are spending money only to generate tax deductions because it is legal, examine whether you really need to spend this money. As an example, if you spend $100 to generate an expense, you will receive $30 in taxes back. If that $100 was not spent in the first place because you didn't really need to spend it, you would keep $100 more. If you are spending $100 no matter what, and you are able to legally expense it, then you are saving that extra $30. Taxes should not drive your financial decisions for the most part, but they can take a situation that is generally neutral, and skew it to a desired outcome. As the person paying the taxes, you should consider whether you would make this transaction with and without the tax implications, and see which outcome works the best for you. This concept would apply to taxes in general, but especially to tax credits.

Tax Strategies Outside the Scope of the Tax Code

Be mindful of tax strategies that save taxes but are outside the scope of the tax code. These are not deemed illegal initially, but if they get too popular, the government may make an official statement that it does not recognize the tax strategy and it is therefore invalid. A good illustration of this scenario is the charity tax credits where people would give money to a charity and earn a greater return that what they contributed. The Canada Revenue Agency eventually shut down this idea as it was deemed abusive. (5) (6) Another example of this situation is the first years of the Tax Free Savings Account (TFSA). There were issues surrounding transfers between the TFSA and the RRSP, and since specific conditions were not stipulated in the tax code, these transfers were assumed to be legal. It turned out that people were charged taxes in hindsight, and the issue was resolved by modifying the TFSA rules at later years. (2) (3) (4) The safest thing to do in these cases is not to delve into these gray areas. If you believe in doing so, acknowledge that there risks and find a tax lawyer who has knowledge in the specific tax idea. Should you get audited or challenged in court, you will have the resources you need.

Running a Business and Taxes

Generally speaking, if you can operate a business versus working for an employer, having a business would allow you to deduct more expenses, and pay fewer taxes all else being equal. There are many implicit assumptions in this statement. The first one is that you can make the identical income at the same time frequency as working as an employee. If you don't think you can generate income consistently, it may not be worth to have a business. The truth is that business income tends to be lumpy and unpredictable. The second one is the deductions. Small businesses pay fewer deductions and less EI, but would pay more in CPP. Insurance may cost more as well if you choose to have it as a business versus being an employee, since the employer subsidizes the insurance costs. Within this point is the assumption that you are running a business at home. Your home expenses would be partially deductible, leading to less tax paid. If you run your business from another location, you will incur more expenses, and the tax situation may be better or worse depending on the net effect of your revenue and expenses. The third point of clarification is that there are different tax rules between being a contractor and a small business. (7)(8) Lastly, the type of business is important. It is fairly simple to be a sole proprietor, but to incorporate involves different costs and commitments. Yes, the corporate tax rate is generally lower than for individuals. However, corporations take more time to operate, have setup costs, legal costs and reporting costs that sole proprietors don't have. Corporations would also have separate HST numbers which is another layer of record keeping over and above that of a sole proprietor. Keep in mind that complexity in general involves more time and effort as well. To incorporate for legal reasons or strategic reasons is a whole other matter. Professionals should be consulted before considering forming a corporation.

These general tax strategies are applicable to most areas of the world, as most governments know how other governments raise tax dollars.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what your options are. **Note: This site is intended for people who want to learn about the world of finance and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**

Sources:

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