CESTNICK

TAX MATTERS

Your New Year's resolutions should include the five pillars of tax planning

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It's nearly 2023, and time to think about your New Year's resolutions. Last year, my resolution was to stop procrastinating, and I still haven't gotten around to it. Comedian Ellen DeGeneres says that we shouldn't be able to create new resolutions until we've finished the old ones. That should keep everyone busy in 2023. She also suggested that Jan. 1 is not the best time to start new resolutions. After all, many people are hungover and have bigger priorities at noon on Jan. 1 – like, where are my pants?

Still, I'd like to suggest a resolution for you to consider for 2023: Make one change that will reduce the taxes you pay. That's it. If you did this every year, the tax savings would compound and make a meaningful difference to your net worth and overall financial well-being.

The question is: What ideas are available to implement? Today, I want to talk about the five pillars of tax planning because any idea that can save you taxes will fall under one of these five pillars. Here they are.

Deducting

This is the idea of claiming deductions and credits to reduce the amount of tax you pay. A deduction will save you taxes equal to the amount deducted multiplied by your marginal tax rate (MTR). For example, if your MTR is 50 per cent, then a $1,000 deduction will save you $500 in taxes ($1,000 x 50 per cent). A tax credit, on the other hand, will reduce your taxes dollar for dollar. So, a $1,000 tax credit will save you $1,000 in taxes. Credits are typically calculated as a percentage (often 15 per cent, federally) of some amount you've disbursed (donations made or medical expenses, for example), or some base amount allowed by our tax law.

Deferring

You can save money by deferring a tax bill, which is simply the idea of pushing a tax bill that would otherwise be due today, to a future year. The idea is that pushing a tax bill to a future year allows you to keep and use those dollars in the meantime. There's value in that. Suppose, for example, you owe $1,000 in taxes but can push that tax bill off for 10 years, and you can earn, say, 6 per cent annually on your money. In this case, you could set aside $558 today, watch it grow to be worth $1,000 in 10 years, then pay your taxes at that time. So, rather than costing you $1,000 today, the tax bill really costs you just $558 in today's dollars.

Dividing

This idea is otherwise known as income splitting. It's the idea of moving taxable income to the hands of other family members so that the taxes are divided among more than one person. This can save meaningful tax dollars because you can use up the lower tax brackets of lower-income folks in the family. The actual taxes saved will vary depending on your province and the difference between your MTR and that of your family member. An Ontario individual who earns $150,000 in 2022 will pay taxes of $44,641 for the year. But if that person was part of a couple who earns $75,000 each (the same $150,000 in total), the couple will pay taxes of $29,718 in total – a full $14,923 (about one-third) less by splitting the income.

Disguising

This idea has nothing to do with putting on a fake mustache and hiding from the Canada Revenue Agency – as fun as that might sound. Instead, it involves "disguising" one type of income that is taxed at a higher rate as another type taxed at a lower rate. Or, more accurately, converting from one type of income to another, if you will. Interest income, for example, is taxed at your full MTR. This is not as attractive as paying tax on capital gains, which today are taxed at half the rate of interest income. Even dividends from Canadian companies that give rise to dividend tax credits are not usually taxed as favourably as capital gains. The highest marginal tax rates on income in Canada look as follows (these are national averages): Interest, regular income (such as employment income), and foreign dividends – 50.5 per cent; eligible Canadian dividends – 35.3 per cent; ineligible Canadian dividends – 44.9 per cent; capital gains – 25.2 per cent.

Dodging

The idea of "dodging" might sound, well, dodgy, but it's perfectly legal. I'm really talking about structuring your financial affairs so that some of the income or financial benefits you receive don't have to show up on your tax return at all. The result is tax-free cash flow or benefits. Structuring your affairs to receive non-taxable amounts might sound like winning the lottery but it is not as difficult as you might think. (By the way, lottery winnings just happen to be tax-free in Canada, but it's not exactly a good wealth-building strategy.)

Now, there are many ideas that fall under each of these pillars of tax planning – and more than I can share today. So, I'll continue the conversation next time where we'll look at specific ideas to consider for 2023.

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