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CESTNICK

TAX MATTERS

Keep cash in your pocket longer with these tips for managing tax instalments

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About 20 years ago, my wife Carolyn called while she was out running errands. She was standing at a bank machine, wanting to make a cash withdrawal, but couldn't remember the PIN for her new card.

I thought for a minute. "Try 8431," I said. She said it didn't work. "Okay, try 8341," I replied. That didn't work either. "Okay, try 4381," I said. "That doesn't work, and the machine just kept my card!" she complained. "Thank goodness for that," I laughed. Mission accomplished. She wasn't impressed.

They say cash is king. Who doesn't want more cash in their pockets? If you're required to pay tax instalments, there may be some clever ideas to help you keep more in your pockets for longer. Let me explain.

The rules

If you have to report income that wasn't subject to withholding tax, as an employee's pay normally is, you might have to make tax instalments during the year. In this case, the Canada Revenue Agency will typically send you a reminder. But don't take it at face value. It's really just a suggestion based on one of the instalment methods our tax law allows. Many people simply pay the amount requested, sending Ottawa money months before it's due.

Tim Cestnick: Buying and selling assets? Understand how to protect capital gains tax treatment

Our tax law says you have to make quarterly tax instalments if your net tax owing exceeds $3,000 ($1,800 for Quebec residents) in the current year and either of the two preceding years. Instalments are normally due on March 15, June 15, Sept. 15 and Dec. 15.

The taxman allows three methods to determine instalments. The simplest is the no-calculation option, where you pay the amounts shown on CRA's reminder (which is based on the prior two years). If you do, you'll generally avoid instalment interest.

The second method is the prior-year option, where instalments are based on last year's tax bill.

Finally, there's the current-year option, which lets you estimate this year's tax and base your instalments on that amount. If your income has fallen, this can significantly reduce your instalments. But if your estimate is too low, instalment interest – and possibly penalties – could apply.

Suppose the CRA suggests instalments totalling $100,000 for the year, but after reviewing your situation and considering the three methods, you're legally required to pay just $50,000. That leaves an extra $50,000 working for you during the year instead of sitting in the government's coffers. It won't reduce your eventual tax bill, but it would leave more cash in your pocket until the balance comes due.

If you're able to consistently keep that extra $50,000 working for you year after year, earning 5 per cent annually, you'll generate roughly $34,000 of additional after-tax investment income over 20 years (at a 31-per-cent marginal tax rate). That's the quiet value of good cash-flow planning.

Tim Cestnick: Beware the pitfalls of not tracking employment tax deductions

The strategies

The goal here is not to avoid paying tax, but to avoid paying before you have to. Try these ideas on for size.

1. Lower income ahead

If you expect your income to be lower this year than last year, use the current-year option. This applies to retirees, business owners whose profits have declined, employees who received a one-time bonus last year, or investors who realized a large capital gain that's unlikely to recur. Too many taxpayers continue paying instalments based on last year's income rather than today's reality.

2. Count deductions and credits

Planning a sizable registered retirement savings plan contribution this year? Or will you be making a sizable donation? What about business or rental losses, or childcare, moving, medical, interest and other expenses? Factor these into your current-year estimate. It could reduce your remaining instalments.

3. Harvest capital losses

If you expect taxable capital gains this year, consider realizing capital losses before year-end. Those losses can offset gains, reduce tax owing and justify smaller instalment payments.

4. Increase tax withholding

Instead of making quarterly instalments, ask your employer, pension administrator or registered retirement income fund carrier to withhold additional tax. Tax withheld at source is generally treated as though paid evenly throughout the year, making it a great substitute for instalments.

5. Alternate dividend years

Business owners who control dividend timing have another planning opportunity. Rather than paying themselves the same dividend every year, consider paying approximately two years' worth every second year. During years when no dividend is paid, your expected tax bill may be much lower, allowing you to reduce or eliminate instalments using the current-year method. The year after, when the larger dividend is paid, your tax bill will increase. But you can use the prior-year method to leave more money invested in your hands during those years.

6. Review midyear

Here we are in August. It's the perfect time to revisit your instalment estimate before the September and December payments. An adjustment can prevent paying tax too early or incurring unnecessary interest.

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