Getting a head start on year-end tax planning (February 2011)

At this time of year, most taxpayers are focused on their tax obligations for the taxation year just ended on December 31, 2010—on the need to file a return for that year, on whether they will be able to come up with an RRSP contribution by March 1, the possibility that there will be taxes owed on filing (or perhaps a refund!), and if there are taxes owing, how to come up with the funds needed to pay that tax bill.

While all of those concerns are valid and pressing ones, the start of a new year is also a good time to start thinking about how to minimize the taxes that will be payable for the current year. While many tax planning strategies can be implemented at any time during the tax year, addressing tax issues at the start of the year can avoid the last minute scramble to verify expenses, locate receipts, and pull together funds for an RRSP contribution with the year-end or even the tax filing deadline for the year looming.

Many taxpayers sit down to prepare their tax returns with the hope that, at the end of the filing process, a tax refund will be forthcoming. The perception persists that a tax refund is a kind of “gift” from the federal government or that it represents “found money” which can only be obtained by filing a tax return. The reality is, in fact, the complete opposite. A tax refund is just that—the return by the federal government of taxes which have been overpaid by the taxpayer during the course of the year. And, in most cases, there is no interest paid by the federal government on that overpayment. Very few taxpayers would, if asked, willingly overpay their taxes and wait for a year, without receiving interest, to get that overpayment back. But every year, millions of taxpayers who collect a refund on filing have done just that.

Consequently, the first step in current year tax planning is to make sure that taxes aren't being overpaid. The majority of working Canadians earn income from employment and, as required by law, the employer deducts income tax from the employee's pay and remits it on the employee's behalf to the federal government. The amount deducted is based on an estimate of the employee's income tax liability for the year; the starting point for determining that liability is the TD1 form for the year. All employees, when they start a new job, must complete a TD1 (actually two TD1s, one for federal purposes and the other for the taxpayer's province or territory of residence). On that form the taxpayer specifies the personal tax credits for which he or she is eligible. Everyone gets the basic personal credit, but the taxpayer must specify which other credits (spousal or equivalent to spouse credit, tuition and education amounts, caregiver credit) he or she will be able to claim in order for the deductions made for income tax purposes to reflect those claims. Often, once an employee has completed the TD1 forms when starting employment, the assumption is made that his or her tax situation has not changed since then, and the deductions made from the employee's paycheque don't change either. However, change comes to everyone's life—a child is born or an older child goes off to university and tuition fees must be paid or an elderly parent can no longer live independently and moves in with an adult child. In some cases, the taxpayer or a spouse must cut back on work hours or even leave work to provide care for that parent. Each of these events, and many others, have tax consequences which will affect the amount of tax payable. A taxpayer who hasn't filled out a TD1 for a few years, or whose personal circumstances have changed, should review the TD1 form (the federal form is available on the Canada Revenue Agency (CRA) Web site at http://www.cra-arc.gc.ca/E/pbg/tf/td1/td1-11e.pdf) to make sure that the form on file with the taxpayer's employer accurately reflects the taxpayer's current circumstances.

While the TD1 form captures most of the non-refundable tax credits for which an individual taxpayer might be eligible, it does not and cannot reflect the various deductible expenses that a taxpayer might incur over the course of the tax year. At this time of year the deduction which is most on everyone's mind is, of course, the RRSP contribution. Human nature being what it is, most Canadians don't think about RRSPs until the contribution deadline of March 1st is near, and most then have difficulty coming up with the funds to make a contribution on such short notice. Financial advisors continually remind Canadians that it is better, for several reasons, to contribute to one's RRSP throughout the year, rather than waiting until the last minute to do so. What most taxpayers don't realize is that it is possible to get an “assist” from our tax system to do so.

That “assist” comes from taking advantage of an administrative policy of the Canada Revenue Agency, using a form (the T1213) entitled *Request to Reduce Tax Deductions at Source*, available on the CRA Web site at http://www.cra-arc.gc.ca/E/pbg/tf/t1213/t1213-10e.pdf. Essentially, a taxpayer who will be incurring costs during the tax year that are deductible in the computation of taxable income for that year but which do not appear on the TD1 can apply, using Form T1213, to have the amount of income tax deducted from his or her paycheque reduced to take account of those costs. The biggest and most well-known of those deductions is an RRSP contribution, but it's not the only one. Taxpayers who incur child care expenses, make deductible support payments, make charitable donations, or have deductible employment expenses and can document the payment and amount of those costs can ask the CRA to authorize a reduction in the income tax deductions made from the taxpayer's gross income to reflect those costs.

The resulting increase in take-home pay can be significant. A middle-income taxpayer—one earning around $50,000 per year—will have source deductions reduced (and therefore take-home income increased) by about one-third of the amount of the deduction claimed. Where the taxpayer's income is over $80,000, that decrease in source deductions can rise to just under 40% of the amount of the expense claimed. And for a taxpayer in the highest income tax bracket (more than about $125,000), the percentage is about 45%.

Take, for example, the taxpayer in that highest income earning bracket who wants to make an RRSP contribution of $10,000. To do so, a monthly contribution of $833 throughout the year would be needed. If, however, income tax deductions at source were reduced to take account of that RRSP contribution, the taxpayer's “take-home” income would increase by $375 per month, or nearly half of the amount needed to make that monthly RRSP contribution.

Finally, many taxpayers incur expenses throughout the year for which a tax credit can be claimed on the return—public transit costs, for instance, interest payments on government student loans, or medical expenses. Whatever the expense, it is up to the taxpayer to prove that the expenditure was made and to document the amount that was paid. In many cases, the taxpayer must forgo making any claim because the receipts needed to prove that claim weren't kept or can't be found at tax filing time. It is not necessary to maintain a sophisticated filing system for such paperwork—just keeping all receipts in one place, to be sorted and organized at tax filing time, is all that is needed.

Tax planning is often thought of as a complex and time consuming process, available only to wealthy and sophisticated taxpayers. But the fact is also that a great deal of tax “planning” can be accomplished with only some straightforward paperwork and basic organization, strategies that are available to anyone who is willing to invest a little upfront time and effort.