

It's 2018 – Do you know what your tax rate is?

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Tax rates can vary with changes in government legislation and your level and type of income. Do you know what your tax rate will be in 2018? This Report will help you to understand how your income is taxed and why the “advertised” tax rate isn’t always what you end up paying.

Graduated tax rates

Canadian individuals pay taxes at graduated rates, meaning that your rate of tax gets progressively higher as your taxable income increases. Figure 1 shows the federal tax rates that apply at various levels of taxable income for 2018.

Figure 1: Federal tax rates at varying levels of taxable income in 2018

Taxable income	2018
≤ \$46,605	15.0%
> \$46,605 and ≤ \$93,208	20.5%
> \$93,208 and ≤ \$144,489	26.0%
> \$144,489 and ≤ \$205,842	29.0%
> \$205,842	33.0%

For example, on the first \$46,605 of taxable income, you would pay federal tax at a rate of 15%. In contrast, taxable income exceeding \$205,842 is taxed at 33%.

Income inclusions, deductions & credits

While graduated tax rates are applied to “taxable income,” not all income is included and certain amounts may be deducted in determining taxable income, thereby reducing the base to which marginal tax rates are applied.

Capital gains are an example of income that is only partially taxed. Unlike interest income that is fully included in taxable income, only 50% of capital gains (less capital losses) are included. The remaining 50% is excluded from income and tax is saved at your marginal rate on this excluded half of net capital gains.

For example, let's say you realized net capital gains of \$10,000 from the sale of shares. Only half of this amount (\$5,000) would be taxed. If instead you earned interest income of \$10,000, you would pay tax on the entire amount.

Common deductions that you may subtract from your total income, thereby decreasing your taxable income, include investment management fees for non-registered accounts, contributions to a Registered Retirement Savings Plan (RRSP), and child care expenses.

In contrast to deductions, tax credits directly reduce the tax you pay after marginal tax rates have been applied to your taxable income. With tax credits, a fixed rate is applied to eligible amounts and the resultant credit amount offsets taxes payable. Figure 2 shows that when the federal tax credit rate of 15% is applied to a \$1,000 amount, \$150 of tax savings results.

Common federal non-refundable tax credits include the basic personal amount, the amount for a spouse or partner, medical expenses and charitable donations.

A non-refundable tax credit is also available to investors who receive dividends from Canadian corporations, to recognize the fact that tax was already paid on the income by the corporation. Canadian dividends are typically classified as either "eligible" or "non-eligible."

Eligible dividends are most commonly received from Canadian publicly-traded companies or mutual funds that hold Canadian dividend-paying equities. An enhanced dividend tax credit is available to an individual who receives eligible dividends to compensate for the high rate of tax that was paid when income was initially earned and taxed in the corporation.

Non-eligible dividends would typically be received from a private Canadian corporation that paid tax on its corporate income at the low, small business rate. Because tax is paid at a low rate in the corporation, a lower dividend tax credit is available to an individual for non-eligible dividends.

Let's look at an example that shows how a tax deduction yields tax savings at the marginal tax rate that varies with your income level, while a tax credit yields tax savings at a fixed rate. Suppose you have total income of \$50,000 and claim either a \$1,000 deduction (e.g. an RRSP contribution) or claim a federal non-refundable credit for \$1,000 (e.g. CPP premiums). Figure 2 shows how deductions and credits reduce the tax that you pay.

The amount of the deduction is subtracted from income, so that this amount of income is not taxed. In Figure 2, a \$1,000 tax deduction yields \$205 of tax savings, calculated as the \$1,000 deduction multiplied by the marginal tax rate that would have applied to the income (20.5%). Consequently, a deduction yields tax savings at your marginal tax rate.

Figure 2: Value of a \$1,000 federal tax deduction and tax credit

	No deduction or credit	Tax deduction	Tax credit
Total income	50,000	50,000	50,000
Deductions (e.g. RRSP deduction)	n/a	(1,000)	n/a
Taxable income	50,000	49,000	50,000
Tax @ 15% on first \$46,605	(6,991)	(6,991)	(6,991)
Tax @ 20.5% on remaining income	(696)	(491)	(696)
Total tax payable before credits	(7,687)	(7,482)	(7,687)
Tax credit (\$1,000 @ 15%) (e.g. CPP premiums)	n/a	n/a	150
Total tax payable	(7,687)	(7,482)	(7,537)
Value of deduction / credit		205	150

Figure 3: Combined federal / provincial marginal tax rates with \$50,000, \$100,000 or \$250,000 of ordinary income, capital gains or eligible dividends in 2018

	\$50,000			\$100,000			\$250,000		
	Ordinary income	Capital gains	Eligible dividends	Ordinary income	Capital gains	Eligible dividends	Ordinary income	Capital gains	Eligible dividends
AB	30.5%	15.3%	7.6%	36.0%	18.0%	15.2%	47.0%	23.5%	30.3%
BC	28.2%	14.1%	7.6%	38.3%	19.2%	18.3%	49.8%	24.9%	34.2%
MB	33.3%	16.6%	14.1%	43.4%	21.7%	28.1%	50.4%	25.2%	37.8%
NB	35.3%	17.7%	8.7%	42.5%	21.3%	18.6%	53.3%	26.7%	33.5%
NL	35.0%	17.5%	20.1%	41.8%	20.9%	29.5%	51.3%	25.7%	42.6%
NS	35.5%	17.7%	16.0%	43.5%	21.8%	27.1%	54.0%	27.0%	41.6%
ON	29.7%	14.8%	7.6%	43.4%	21.7%	25.4%	53.5%	26.8%	39.3%
PEI	34.3%	17.2%	12.1%	44.4%	22.2%	24.6%	51.4%	25.7%	34.2%
QU	37.1%	18.6%	17.5%	45.7%	22.9%	29.4%	53.3%	26.7%	39.8%
SK	33.0%	16.5%	9.6%	38.5%	19.3%	17.2%	47.5%	23.8%	29.6%

Source: EY 2018 Personal tax calculator, which reflects known rates as of January 15, 2018

On the other hand the \$1,000 of CPP premiums generates a federal non-refundable credit of 15%, yielding a federal tax savings of only \$150. When you add provincial tax savings to the federal savings above, the total tax savings can range from 20% for the combined credits to more than 50% for a deduction.

Marginal tax rate

Your marginal tax rate is the amount of tax you would pay on an additional dollar of income. In addition to the graduated federal tax rates shown in Figure 1, provincial taxes are applied to your taxable income before allowing for credits.

Figure 3 shows the combined federal and provincial marginal tax rates that apply to various types of income for an individual with \$50,000, \$100,000 or \$250,000 of taxable income, allowing for a 50% inclusion of capital gains and the dividend tax credit on eligible dividends.

For example, Figure 3 shows that in Alberta in 2018, the marginal tax rate for an individual who

earns \$50,000 of ordinary income is 30.5% (20.5% federal rate plus 10% Alberta rate). Since only 50% of capital gains are included in taxable income, the marginal tax rate for capital gains is 15.3%, or 50% of the marginal tax rate for ordinary income. And, due to the dividend tax credit, the marginal tax rate for eligible dividends is just 7.6%.

Average tax rate

The second tax rate to be considered is your average tax rate, which is typically much lower than your marginal tax rate, and is simply calculated as the amount of tax you pay, divided by your total income. So, for the same individual in Alberta in 2018 who earns \$50,000 of ordinary income, the combined federal and provincial tax liability in 2018 would be about \$9,000, allowing for only the basic personal credit. This results in an average tax rate of about 18% (\$9,000 / \$50,000) – significantly below the 30.5% marginal rate.

Figure 4 compares the marginal and average tax rates for various levels of ordinary income across the provinces in 2018.

Figure 4: Marginal and average tax rates with \$50,000, \$100,000 or \$250,000 of ordinary income in 2018

	\$50,000		\$100,000		\$250,000	
	Marginal tax rate	Average tax rate	Marginal tax rate	Average tax rate	Marginal tax rate	Average tax rate
AB	30.5%	18.1%	36.0%	24.7%	47.0%	35.0%
BC	28.2%	16.4%	38.3%	23.4%	49.8%	36.5%
MB	33.3%	21.3%	43.4%	29.1%	50.4%	39.7%
NB	35.3%	20.4%	42.5%	28.5%	53.3%	40.4%
NL	35.0%	20.4%	41.8%	28.4%	51.3%	39.4%
NS	35.5%	21.6%	43.5%	29.7%	54.0%	41.3%
ON	29.7%	16.4%	43.4%	24.6%	53.5%	38.7%
PEI	34.3%	21.5%	44.4%	29.3%	51.4%	40.3%
QU	37.1%	21.1%	45.7%	30.0%	53.3%	42.1%
SK	33.0%	19.2%	38.5%	26.5%	47.5%	36.6%

Source: EY 2018 Personal tax calculator, which reflected known rates as of January 15, 2018

Let's take a look at three examples and review how the type of income you earn can have a significant impact on your marginal and average tax rates.

Example 1

Angelica lives in B.C. and earns \$50,000 of employment income in 2018. Assuming only the basic personal amount, she will pay about \$8,200 in tax, yielding an average tax rate of 16.4% ($\$8,200 / \$50,000$). Her marginal tax rate would be 28.2% on each additional dollar of ordinary income. On capital gains, her marginal tax rate would be half that or 14.1% while on Canadian eligible dividend income, her marginal tax rate would be a mere 7.6%.

Example 2

Eliza lives in Ontario and earns \$50,000 of investment income in 2018, comprised of \$10,000 of interest income, \$20,000 of realized (gross) capital gains and \$20,000 of Canadian eligible dividends. Assuming only the basic personal amount as well as the applicable dividend tax credit, her total tax bill would be a mere \$1,300 and her average tax rate only 2.6% ($\$1,300 / \$50,000$). The reason for such a low rate stems primarily from the dividend tax credit,

which not only eliminates her tax bill on the dividend income but acts as a tax shield to recover some of the taxes she would otherwise pay on her interest income and capital gains.

Example 3

Peggy lives in Manitoba and earns \$50,000 of employment income, contributes \$5,000 to an RRSP and has \$5,000 of tuition credit amount carryforward from when she was a student. She makes \$1,200 in charitable donations annually. Taking into account her RRSP deduction, the basic personal amount and her tuition and donation credits, her 2018 tax bill would be about \$7,300, resulting in an average tax rate of about 15%.

Conclusion

We can see from the examples above that, while all three taxpayers had \$50,000 of income, their average tax rates ranged from 2.6% (Eliza) to 16.4% (Angelica). We can see that both the type of income (e.g. employment, dividends and capital gains) and the opportunity to claim various deductions (e.g. RRSP contribution) and credits (e.g. tuition, donation, etc.) all can have a significant impact on your average tax rate and the tax you ultimately pay.

Marginal effective tax rate

There is a third type of rate that must also be kept in mind for some taxpayers: Marginal Effective Tax Rate (METR). Similar to the marginal tax rate, the METR goes a step further by comparing the amount of tax paid on an additional dollar of income, taking into account not only the statutory federal and provincial income tax bracket thresholds and rates, but also the potential loss of income-tested tax deductions, credits and government benefits. That is, many government benefits, credits and programs are based on net income and are substantially or even totally reduced as your income gets higher.

For instance, both the “age credit” and the GST / HST credit are income tested, as is the Guaranteed Income Supplement (GIS), and Old Age Security (OAS) benefit payments (see Figure 5). As income increases, these credits and benefits may be reduced or even eliminated altogether.

Figure 5: A sample of various 2018 federal income tested benefits & credits¹

	Maximum value	Income threshold	
		Begins	Ends
Old Age Security	\$ 7,040	\$75,910	\$122,843
Guaranteed Income Supplement – Single	10,515	17,760	38,790
Age credit (federal)	1,100	36,976	85,863
GST / HST Credit – Single	427	36,429	44,969

For example, in 2018, the OAS clawback begins when income is over approximately \$76,000 and results in the OAS being fully clawed back once income reaches approximately \$123,000. The clawback of OAS alone can produce METRs of well over 50%, depending on your income and province of residence.

As withdrawals from a TFSA (unlike RRSP or RRIF withdrawals) are not considered “income” and do not impact income-tested benefits, such as the OAS. The potential for a future OAS clawback can sometimes influence the decision on whether to currently contribute to a TFSA or an RRSP. Similarly, future eligibility for the GIS and Age Credit may also impact such a decision.

It’s not just top income earners who face high METRs with loss of government benefits, since many benefit programs target lower-income individuals and families. For example, the Canada Child Benefit provides up to \$6,496 for each child under age six and up to \$5,481 for each child between ages 6 and 17; however, it is phased out based on the number of children and adjusted family net income.

A 2018 C.D. Howe Institute report² found that “METRs generally peak at family incomes between \$35,000 and \$50,000,” with families in Ontario and Quebec facing METRs of up to 64% and 73%, respectively. The report found that benefit reductions can discourage low income earners from taking on extra employment to get ahead because there is a “penalty that must be paid out of the total income derived from entering the workforce.”

Failing to consider your METR, along with your marginal and average tax rates, in your financial planning discussions may lead to unintended consequences down the road.

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- ¹ Figure 5 reflects Old Age Security (OAS) and Guaranteed Income Supplement (GIS) amounts for the period from January to March 2018, and GST / HST Credit amounts for the period from July 2017 to June 2018.
- ² “Two-Parent Families with Children: How Effective Tax Rates Affect Work Decisions”, Alexandre Laurin, C.D. Howe Institute, January 9, 2018, which is available online at https://www.cdhowe.org/sites/default/files/attachments/research_papers/mixed/METRs%20for%20Families%20E-Brief.pdf.



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