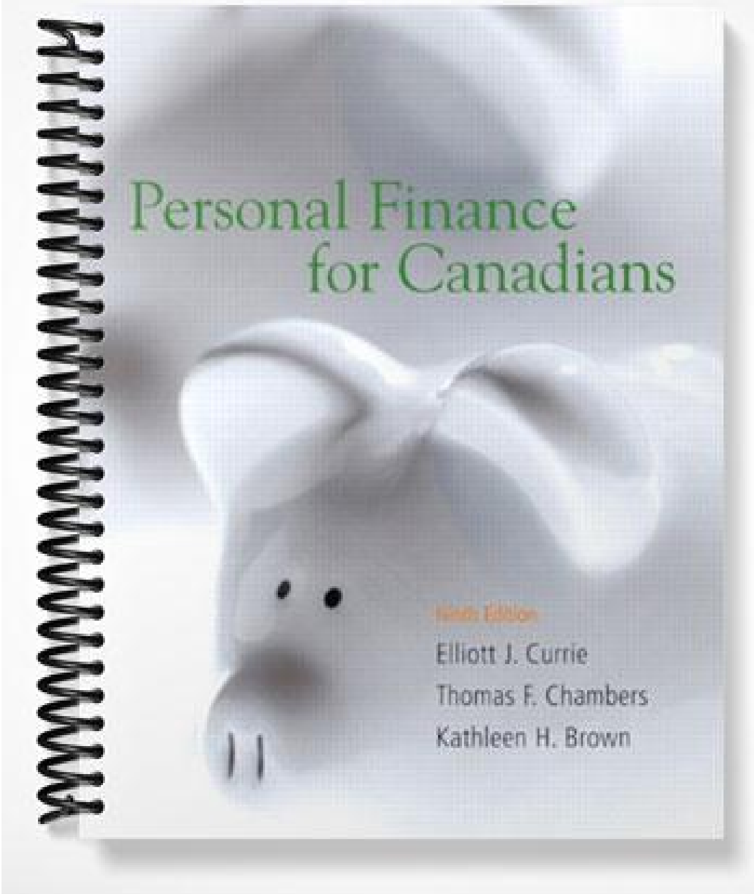
SOLUTIONS MANUAL



Chapter 2
Introduction to Personal Income Tax

INTRODUCTORY NOTES

The federal and provincial governments assess taxes against the income of Canadians. The income tax rules are created to a large extent by the federal government, which can and does change them frequently. Consequently, it is virtually impossible to create a textbook that can remain up to date for any length of time. The intent of this chapter is to provide an understanding of the basic tax concepts and principles and thus create a framework for organizing the changing specific information. Technical terms associated with income tax, such as taxable income, marginal tax rate, tax credit, capital gains, and before and after tax dollars are covered. Only through following the financial press can the students and instructors even come close to being up to date on the changes in income tax.

ANSWERS TO THE PROBLEMS

1. Income tax return.
   a. No. The income tax on the estate was paid before distribution.
   b. No. These are exempt from income tax, but the interest earned on the winnings is taxed.
   c. Yes. The OAS is taxable, while the GIS and SPA are not
   d. No. There are no taxes on capital gains from the sale of a primary residence.
   e. Yes. See the definition of income for tax purposes.
2. Both. There is a deduction for childcare expenses, a non-refundable tax credit for dependent children, and a refundable tax credit for those whose incomes are low enough and claim their eldest child as equivalent to spouse for credit.
3. Agree or disagree.
   a. Disagree. No income tax is paid on the money put into a tax shelter, so this would be *before-tax* dollars.
   b. Disagree. The proportion of your taxable income paid in income tax is your *average tax rate.*
   c. Disagree. To find taxable income you would subtract deductions such as RRSP contributions, union dues, moving expenses, etc.
   d. Agree.
   e. Agree. There is a tax credit for pension income and an age amount.
   f. Disagree. Adjusted for inflation, the total federal and provincial per capita tax burden has risen steadily from approximately 7 percent of income in 1961 to just over 15 percent in 2005. See Figure 2.2 on page 42.
   g. Disagree. Canadians must file individual tax returns.

h. Disagree. Interest income is taxable and included with other forms of income.
i. Agree.
j. Disagree. The taxes on money put into an RRSP, together with the earnings on that money while inside the RRSP, are deferred until the funds withdrawn.

4. Rather than trying to complete a tax return, it may be much more beneficial to complete the exercise online using the Morningstar calculator at the following website: Marginal Tax Rate Calculator, Morningstar
5. In deciding use the $6000 to reduce the mortgage debt or to make an investment, the primary consideration is the *after-tax return* on the investment compared to the interest rate on the mortgage. In this case, you can save 6 percent by paying down the mortgage; however you can earn only 3.05% after tax on the investment calculated as .05(1-.39) x 100%. Therefore, paying down the debt would be the wiser choice. Borrowing to invest would probably cost even more than the 6% mortgage, so that would also be a poor decision. Furthermore, even if the investments were made inside an RRSP, making the tax adjustments irrelevant, the return on investment is still less than the savings from reducing the mortgage debt.

6. Karen's tax return.
   a. An excellent resource for this exercise is the Canada Revenue Agency's Resource Kit at the following link: [2007 Resource Kit: Individuals]

KAREN'S FEDERAL TAX CALCULATION

Income			
	Employment Income	$48,500.00	
	Other Investment Income	$ 950.00	
	50% of Capital Gains	$ 4,250.00	
Total Income			**$ 53,700.00**
Less Deductions			
	RPP Contributions	$ 3,000.00	
	RRSP Contributions	$ 2,500.00	
	Union or Professional Dues	$ 500.00	
	Rent on Safety Deposit Box	$ 25.00	
	Accountant's Fee	$ 250.00	
Total Deductions			**$ 6,275.00**
Total Taxable Income			**$ 47,425.00**
Federal Tax Calculation:			
	15.25% of first $36,378 taxable income	$ 5,548.00	
	22% of next $36,378 taxable income	$ 2,430.34	
Total Federal Tax			**$ 7,978.34**

   b. Karen's federal marginal tax rate is 22 percent, which is the rate she would pay on her next dollar of taxable income.
   c. Karen has *non-refundable* tax credits including the basic personal tax credit, an equivalent to spouse credit (assuming she is unmarried, not living common law, and has a dependent child), credits for Employment Insurance and Canada Pension Plan contributions, as well as credits for the charitable donations. She also has *refundable* tax credits for the political party contribution and for income tax already remitted or withheld, as well as various provincial credits.
   d. It might be useful to actually prepare a tax return for the current year. Follow the link for a good estimate for your province. http://www.morningstar.ca/globalhome/MarginalTaxCalculator/index.asp

7. Tax evasion and tax avoidance.
   a. Tax evasion is knowingly committing an act or omitting an act with the intent to deceive, so that the taxpayer pays less tax than would otherwise be payable under the law. Examples of this illegal activity would include deliberately not reporting income and fraudulently claiming expenses.

b. Tax avoidance, on the other hand, is the taking advantage of ways that are clearly provided for, or not specifically prohibited, by law to legally avoid paying taxes. Unfortunately, there are very, very few ways of avoiding the paying of taxes all together.
    i. The main way involves using the capital gains exemptions such as the principal residence exemption, the exemption on disposition of shares in a qualified small business corporation, and the exemption on disposition of qualified farm property.
    ii. Another possibility of avoiding income tax is through the use of a life insurance policy, whereby the beneficiary pays zero tax on the insurance proceeds. Sadly the taxpayer must die to activate this avoidance measure.
    iii. Taxes may also be reduced by deferring taxes through investing inside an RRSP; transferring tax credits to another family member, such as the education credit if the student can't use it; or by income splitting, such as with spousal RRSPs or employing family members in your own business.

8. The following link will help with this comparative analysis: http://www.morningstar.ca/globalhome/MarginalTaxCalculator/index.asp
9. Suggest that the students check out this link also: http://www.morningstar.ca/globalhome/MarginalTaxCalculator/index.asp .

SUPPLEMENTARY ACTIVITIES

1. Encourage your students to take this National Post's ten-question true and false quiz. The answers and explanations are provided. Check it out at "Your Taxes: A True or False Quiz" in the National Post, April 28, 2007.
2. What are the provincial tax credits for residents of your province? Are they limited to any population groups? Follow the link for a discussion by the Certified General Accountant's Association of Ontario of tax credits available in Ontario. Ontario Provincial Tax
3. What are the tax credits or deductions available to students? Follow the link for lots of ideas to complete this activity. H&R BLOCK - Your Life | Tax Breaks for Students
4. Have the students check out the Fraser Institute's personal tax calculator at Personal Tax Freedom Day Calculator